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1983–84 MISCELLANEOUS TAX BILLS—VI: S. 1066, S. 1550, S. 1557, AND S. 1666

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
SAVINGS, PENSIONS, AND INVESTMENT POLICY

AND

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1066, S. 1550, S. 1557, and S. 1666

SEPTEMBER 19, 1983

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1983-84 Miscellaneous Tax Bills—VI

MONDAY, SEPTEMBER 19, 1983

U.S. SENATE, SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, AND SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE,

Washington, D.C.

The subcommittees met, pursuant to notice, at 2:05 p.m. in room SD-215, Dirksen Senate Office Building, Hon. John H. Chafee (chairman of the Subcommittee on Savings, Pensions, and Investment Policy) presiding.

Present: Senator Chafee.

[The press release announcing the hearing, the opening statement of Senators Chafee and Pryor, and background information on S. 1066, S. 1550, S. 1557, and S. 1666 and S. 1666, and the text of these bills follow:]

[Press Release No. 83-177]

FINANCE SUBCOMMITTEES ON SAVINGS, PENSIONS AND INVESTMENT POLICY AND TAXATION AND DEBT MANAGEMENT SET JOINT HEARING ON FOUR PENSION AND TAX PROPOSALS

Senator John Chafee, Chairman of the Subcommittee on Savings, Pensions and Investment Policy and Senator Bob packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Committee on Finance, announced today that a joint hearing will be held on Monday, September 19, 1983 on four miscellaneous tax bills.

The hearing will begin at 2:00 p.m. in Room SD-215 of the Dirksen Senate Office Building.

The following legislative proposals will be considered:

S. 1066.—Introduced by Senator Chafee for himself and others. S. 1066 would amend the Employee Retirement Income Security Act (ERISA) to allow employers and employees jointly to purchase an insured annuity contract at the time of an employee's retirement in order to fund a retirement benefit that would supplement benefits available to the employee under a tax-qualified defined benefit plan.

S. 1550.—Introduced by Senator Chafee. S. 1550 would allow a U.S. firm to deduct as a cost of doing business the foreign tax on U.S. "construction contract services" (e.g., engineering, design, management and planning, procurement, and cost scheduling) that are rendered in the United States and are directly related to a construction project located in a foreign country.

S. *1557.*—Introduced by Senators Chafee and Bentsen. S. 1557 would exempt foreign individuals and corporations from the 30 percent withholding tax on interest income (including original issue discount) from the following obligations:

(a) Certain obligations issued and sold to foreign persons prior to the enactment of the bill and assumed by a domestic corporation after the bill's enactment;

(b) obligations sold to foreign persons directly or through underwriters under arrangements designed to insure that their initial sale is only to foreigners; or

(c) obligations that are in registered form and where the withholding agent has received a statement to the effect that the beneficial owner of the obligation is a foreign person.

S. 1666.—Introduced by Senator Chafee for himself and others. S. 1666 would lower to 10 percent the maximum effective capital gains rate of tax imposed upon a sale or exchange of stock that (1) was acquired in an initial stock offering and represents contributions to capital or paid-in surplus, and (2) was held for at least 5 years.

The third bill, S. 1557, "The Capital Tariff Repeal Act of 1983" would exempt foreign persons and foreign corporations from U.S. income and withholding taxes on interest income from debt obligations guaranteed by domestic corporations. Currently, the U.S. levies and withholds a 30 percent income tax on nonresident aliens and foreign corporations receiving interest payments from U.S. corporations. This tax impairs U.S. competition in the worldwide debt market, such as the Eurobond market, and operates as a tariff, hindering the influx of foreign capital to help finance American business. As I understand it, this bill has the support of the Treasury Department.

Out last bill today, S. 1066, "The Supplemental Retirement Benefit Act of 1983" addresses the concerns of retirees facing uncertainty with the future buying power of their private sector pensions. This bill creates a workable mechanism for private pension plans to grant annual cost of living increases. Presently, most private pension plans do not provide cost of living increases for retirees. An article in today's Washington Post indicates that for the larger companies studied, only 3 percent provided for cost of living increases in their pension plans, although some (two-fifths) do adjust the retiree's benefits after the fact on an ad hoc basis.

This bill supplements employee benefits on a non-discriminatory basis, by allowing employers and employees to jointly purchase an insured annuity contract at the time of the employee's retirement in order to fund what we call the "supplemental retirement benefit." These supplemental retirement benefits would be limited to the greater of 3 percent of a retiree's initial pension payment or a percent of the pension equal to the seven year average of the cost of living increase, generally determined by using the consumer price index.

We have a great number of witnesses today to discuss these bills; I only wish this great interest equaled the time scheduled for this hearing. We are delighted to have today as witnesses Congressman Zschau of California and Delegate Won Pat from Guam.

Congressman Zschau has remarkable background in developing new companies in advanced technologies. He will speak generally on S. 1666 and also share with us his other ideas for ways to assist smaller new businesses which are developing as many advanced technologies.

Delegate Won Pat is here to testify on S. 1557. We welcome his testimony on this bill.

Congressman Zschau, we welcome you.

OPENING STATEMENT BY SENATOR JOHN H. CHAFEE AT A JOINT HEARING OF THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY AND THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, SEPTEMBER 19, 1983

Good afternoon. I want to welcome everyone here today. This hearing will focus on four bills representing a range of concerns.

The first bill we will be examining this afternoon is S. 1666, "The Capital Formation Tax Act of 1983." This proposal has been introduced in response to a hearing conducted by this Subcommittee on "The Promotion of High Growth Industries and U.S. Competitiveness." At this earlier hearing, many witnesses testified to the need for incentives to promote capital formation and encourage a stable long-term investment environment that would assist the new so-called "high tech" companies which are developing advanced technologies and providing many benefits to our economy. We learned at those hearings that access to capital is not only critical to smaller new ventures, but also enables more mature companies to be innovative and forge ahead in the development of new advanced technology.

S. 1666 would reduce the maximum effective capital gains rate to 10 percent on issues of stock that are publicly or privately offered through initial stock offerings and that are held for five years. The provisions of S. 1666 attempt to encourage investment in these companies during the most critical years of a new company by requiring that the stock be "initial" issue stock. In addition, the bill rewards investors who stay with a company for five years, during perhaps difficult times and thus provides more certainly for the company which is pursuing risky, but innovative R&D in new technologies.

Our next bill, S. 1550, is designed to correct a problem which has arisen with regard to the double taxation of overseas construction projects undertaken by U.S. contractors. This bill permits a U.S. firm to deduct as a cost of doing business, the foreign taxes paid on "construction contract services" such as engineering, design, procurement and cost scheduling, which are performed in the United States but taxed by the foreign country. The purpose of this bill is to put U.S. firms on par with non-U.S. firms that are not taxed by their home country, and thereby retain and expand overseas construction projects which produce technical service jobs in the U.S.

OPENING STATEMENT OF SENATOR DAVID H. PRYOR, SENATE COMMITTEE ON FINANCE, SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, SEPTEMBER 19, 1983

Mr. Pryor. Mr. Chairman, I'm pleased that the Subcommittee is holding this hearing today on four important tax measures. I'm particularly interested in a couple of these bills and I commend you for your leadership in the area of capital formation and pension policy.

I'm consponsor of S. 1666, a bill you've introduced to reduce the maximum capital gains rate of 10% for certain qualified stock held for more than five (5) years. I think this idea is strongly supported by many groups, and I know many people in the business community in the State of Arkansas think it's a good concept.

I'm also interested in S. 1066, Mr. Chairman, and look forward to hearing the testimony on that bill. Civil Service and Social Security benefits are indexed, but many people who've retired from private sector jobs have no way to keep up with the cost of living after retirement. S. 1066 provides a mechanism for doing so through a supplemental retirement benefit.

I know there's a considerable amount of interest in the other two bills before the subcommittee today. I look forward to the testimony and look forward to working with you and other members of the committee on these measures.

DESCRIPTION OF TAX BILLS
(S. 1066, S. 1550, S. 1557, and S. 1666)

SCHEDULED FOR A JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

AND THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON

SEPTEMBER 19, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on September 19, 1983, jointly before the Senate Finance Subcommittees on Savings, Pensions and Investment Policy and on Taxation and Debt Management.

The four bills scheduled for the hearing are (1) S. 1066 (the "Supplemental Retirement Benefit Act of 1983"); (2) S. 1550 (relating to the treatment of foreign income taxes on certain U.S. construction contract services); (3) S. 1557 (relating to exemptions from U.S. tax for interest paid to foreign persons); and (4) S. 1666 ("Capital Formation Tax Act of 1983").

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, issues, and effective dates.

I. SUMMARY

1. S. 1066 — Senators Chafee, Bentsen, and Baucus

"Supplemental Retirement Benefit Act of 1983"

Present law

Under present law, a qualified defined benefit pension plan may provide cost-of-living increases to the retirement benefits of retired employees if the overall limits on contributions and benefits under qualified plans are satisfied. These cost-of-living increases are treated the same as other benefits under the plan and, therefore, are subject to minimum standards relating to participation, vesting, benefit accrual, and funding. The benefits (including cost-of-living increases) may be guaranteed by the Pension Benefit Guaranty Corporation (PBGC). Generally, benefits under a qualified plan are not includible in gross income until they are distributed by the plan. In addition, employer contributions to qualified plans are deductible within limits when contributed to the plan.

Present law also permits cost-of-living increases to be provided in a nonqualified supplemental plan. If a supplemental plan meets certain standards prescribed by the Department of Labor, the plan is classified as a welfare plan rather than a pension plan and, consequently, the plan is not subject to the minimum participation, vesting, benefit accrual, and funding standards applicable to pension plans. If the benefits are paid to the employee from the general assets of the employer, they will generally be taxable to the employee and deductible by the employer when they are paid. If the benefits are provided under a separate earmarked trust, however, the benefits generally are taxable to the employee and deductible by the employer when the employee's right to receive the amounts is no longer subject to a substantial risk of forfeiture.

S. 1066

The bill would permit an employer to provide (through employer contributions or a combination of employer and employee contributions) a "qualified supplemental benefit" under a qualified defined contribution plan to supplement the benefit under one or more defined benefit pension plans of the employer. The maximum supplemental benefit that could be provided by employer contributions would be the greater of (1) three percent of the primary retirement benefit or (2) a percentage of the primary retirement benefit equal to a seven-year average of the cost—of living—increase (generally determined using the Consumer Price Index). Additional supplemental benefits could be provided by employee contributions.

Amounts contributed by the employer to provide qualified supplemental benefits would not be subject to the overall limits on annual additions to defined contribution plans and would be deductible when paid by the employer regardless of the usual limits on deductions. Qualified supplemental benefits would not be includible in income until the benefits are actually paid to the employee even though the employee has a nonforfeitable right to the benefit at an earlier date. Benefits provided under the qualified supplemental benefit arrangement would not be guaranteed by the PBGC.

The bill would generally be effective for taxable years beginning after 1982. The provision of the bill relating to the overall limits on contributions and benefits under qualified plans would be effective for years (within the meaning of Code sec. 415) beginning after 1982.

2. S. 1550 — Senators Chafee, McClure, and Grassley

Treatment of Foreign Income Taxes on Certain U.S. Construction Contract Services

Under current law, U.S. taxpayers must either deduct all foreign income taxes or credit all foreign income taxes. The bill would allow U.S. taxpayers (1) to elect to deduct foreign income taxes imposed on construction contract services (generally, architectural, engineering, and similar services) performed in the United States for use in a foreign country and (2) to credit all other foreign income taxes. Taxpayers would make this election on a country-by-country and year-by-year basis. The bill would be effective for taxable years ending after 1982.

3. S. 1557 — Senators Chafee and Bentsen

Exemptions from U.S. Tax for Interest Paid to Foreign Persons

Under present law, a U.S. withholding tax of 30 percent is generally imposed on annuities, interest, dividends, rents, royalties, and similar payments by U.S. persons to foreign investors if the payments are not effectively connected with a U.S. trade or business conducted by the foreign investor. Exemptions from the withholding tax are provided in certain situations. In addition, U.S. tax treaties generally reduce or eliminate the withholding tax on interest paid to treaty country residents.

The bill would repeal the 30-percent withholding tax on interest paid to foreign investors on portfolio indebtedness. The withholding tax on interest paid to foreign investors would continue only in some (but not all) cases where the foreign investor is related to the U.S. obligor, where the foreign investor is controlled by U.S. persons, or where the foreign investor is a bank. Obligations yielding tax-exempt interest would also be exempt from U.S. estate tax.

The provisions of the bill would be effective for interest paid and after the date of enactment. The estate tax exemption would apply to deaths of decedents after the date of enactment.

4. S. 1666 — Senators Chafee, Bentsen, Durenberger, Boren, Wallop, and Pryor, and others

"Capital Formation Tax Act of 1983"

Under present law, gain or loss from disposition of a capital asset held for more than one year receives special tax treatment. Noncorporate taxpayers may deduct from gross income 60 percent of their net capital gains. As a result, net capital gains of noncorporate taxpayers are taxable under current law at a maximum 20-percent rate.

The bill would increase the deduction to 80 percent for net capital gains of noncorporate taxpayers attributable to dispositions of stock acquired through certain initial stock offerings and held by the taxpayer for at least five years. Thus, for noncorporate taxpayers subject to the 50-percent maximum regular rate, net capital gains attributable to dispositions of such stock would be taxable at a maximum 10-percent rate (assuming the alternative minimum tax did not apply). The bill would apply to sales or exchanges of such stock occurring after 1983.

II. DESCRIPTION OF THE BILLS

1. S. 1066 — Senators Chafee, Bentsen, and Baucus

"Supplemental Retirement Benefit Act of 1983"

Present Law

In general

Qualified defined benefit plans

Under present law, if an employer maintains a qualified defined benefit pension plan[1] for its employees, the plan is required to meet certain minimum standards relating to employee eligibility for plan participation, vesting, the rate at which benefits are accrued, and the rate at which the employer must contribute to the plan to fund the benefits. In addition, certain benefits provided under qualified defined benefit pension plans are guaranteed by the Pension Benefit Guaranty Corporation (PBGC).

Overall limits are provided with respect to the amount of retirement benefits that may be provided under a qualified defined benefit plan and the extent to which an employer may deduct contributions to provide these benefits.

Under present law, a qualified defined benefit pension plan may provide cost-of-living increases to the retirement benefits of retired employees if the overall limits on contributions and benefits under qualified plans are satisfied. These cost-of-living increases are treated the same as other benefits under the plan and, therefore, are subject to the minimum standards relating to participation, vesting, benefit accrual, and funding, and may be guaranteed by the PBGC. Generally, cost-of-living increases under a qualified plan are not includible in income until they are distributed.

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[1] Under ERISA, a pension plan is any plan, fund, or program that is established or maintained by an employer and provides retirement income to employees or results in a deferral of income to periods extending to the termination of covered employment or beyond (Sec. 3(2) of the Employee Retirement Income Security Act of 1974 (ERISA)). If a pension plan qualifies under the tax law (Code sec. 401(a)) then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are accorded special long-term capital gain or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account (IRA) or to another qualified plan, and (4) limited estate and gift tax exclusions may be available. A qualified defined contribution plan is a tax-qualified plan under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants. A qualified defined benefit pension plan is a tax-qualified plan that specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

Qualified defined contribution plans

If an employer maintains a qualified defined contribution plan, the plan is required to meet the minimum standards relating to participation, vesting, and, in the case of certain defined contribution plans, funding. Benefits under defined contribution plans, however, are not guaranteed by the PBGC.

Overall limits are provided with respect to the amount of the annual addition (i.e., employer contributions, a portion of the employee contributions, and reallocated forfeitures) credited to an employee's account for a year under a qualified defined contribution plan. In addition, there are limits on the extent to which an employer may deduct contributions to these plans.

Under present law, if an employer makes a one-time contribution to a qualified defined contribution plan for the purchase of an annuity contract to provide cost-of-living adjustments to benefits under the employer's defined benefit plan, the contribution may not cause the annual additions for the year with respect to a participant to exceed the overall limits.

Qualified plan requirements

Minimum participation

Under present law, a qualified plan (defined benefit or defined contribution) generally may not require, as a condition of plan participation, that an employee complete more than one year of service or attain an age greater than 25 (Code sec. 410).

Vesting

The rules relating to qualified plans generally require that a plan meet one of three alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions become nonforfeitable (vest) to varying degrees upon completion of specified periods of service with an employer.

Under one of these schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the tenth year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. Under these two vesting schedules, all years of service with the employer maintaining the plan after attainment of age 22 generally must be taken into account for purposes of determining an employee's vested percentage. The third schedule takes both age and service into account, but in any event requires 50 percent vesting after 10 years of service and an additional 10 percent vesting for each year thereafter until 100 percent vesting is attained after 15 years of service. Under this schedule, all years of service with the employer must be taken into account for purposes of determining an employee's vested percentage if, during those years, the employee participated in the plan.

For years beginning after 1983, more rapid vesting is required under a top heavy plan.

Benefit accruals

Present law requires that a participant in a qualified plan accrue (earn) the benefit provided by the plan at certain minimum rates (Code sec. 411(b)). The accrual rules are designed to limit backloading of benefits. Under a backloaded accrual schedule, a larger portion of the benefit is earned in later years of service.[2] Accordingly, under a plan with backloaded accruals, an employee who separates from service before reaching retirement age earns a disproportionately lower share of the benefit payable at retirement age.

Funding

Present law requires that the benefits provided under a qualified defined benefit plan must be funded by the employer at certain minimum rates based on reasonable actuarial assumptions and the use of acceptable funding methods. These funding rules are designed to ensure that the plan will have sufficient assets to pay the participant's benefits when the participant retires. Certain defined contribution plans are also subject to minimum funding requirements.

Nondiscrimination

The benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. In addition, the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. The coverage rules provide that a qualified plan must include as participants enough employees to satisfy one of the following tests: (1) 70 percent of all employees, (2) 80 percent of all eligible employees if at least 70 percent of all employees are eligible, or (3) coverage of employees who qualify under a classification that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (Code sec. 410(b)).

Limits on contributions and benefits

Under a qualified defined contribution plan, the overall limit on the annual addition with respect to each plan participant generally is the lesser of (1) 25 percent of compensation for the year or (2) $30,000.[3] Under a qualified defined benefit plan, the annual benefit derived from employer contributions generally is limited to the lesser of (1) 100 percent of high three-year average compensation or (2) $90,000.[4] If an employee participates in a qualified defined contribution plan and a qualified defined benefit plan maintained by the same employer, the fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit.

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[2] For example, a plan's benefit formula might provide a benefit equal to two percent of average compensation multiplied by the number of years of plan participation. Under the minimum standards, a plan's accrual formula might provide that 2-1/7 percent of this benefit is earned for each of the first 20 years of service and that 2-6/7 percent of the benefit is earned for each of the next 20 years of service. An employee who separated after 20 years of service would have earned 42-6/7 percent (2-1/7 percent X 20) of a benefit equal to 40 percent (two percent X 20) of average compensation. The benefit would be 17-1/7 percent of the employee's average compensation (42-6/7 percent X 40 percent of average compensation). If the benefit accrual had been equal for each year of plan participation (2-1/2 percent of the benefit per year of participation), the benefit earned would have been 20 percent of average compensation (20 X 2.5 percent X 40 percent).

[3] Beginning in 1986, this amount will be adjusted for inflation.

[4] Beginning in 1986, this amount will be adjusted for inflation.

In addition, present law provides that no deduction by the employer is permitted for any year for employer contributions used to provide any benefits or annual additions in excess of the overall limits applicable to that year. Thus, in the case of a qualified defined benefit plan, no benefits in excess of the overall limits may be taken into account for purposes of computing the applicable deduction limit. Similarly, contributions taken into account in computing an employer's deduction for contributions to a qualified defined contribution plan must be reduced by the amount by which the annual addition for an employee exceeds the overall limit for the employee.

Guarantees

Under present law, a qualified defined benefit pension plan must pay annual premiums to the PBGC for each plan participant. The PBGC guarantees certain plan benefits in the event the plan terminates when there are insufficient assets to pay guaranteed benefits. Benefits under qualified defined contribution plans are not guaranteed by the PBGC.

Supplemental retirement benefits

A qualified defined benefit pension plan may provide for cost-of-living adjustments to the benefits of retired employees. These adjustments, however, may not cause the benefits under the plan to exceed the overall limits under qualified plans. Similarly, an employer may make a one-time contribution to a qualified defined contribution plan for the purchase of an annuity contract to provide cost-of-living adjustments to benefits under the employer's defined benefit plan if the contribution does not cause the annual addition with respect to any plan participant to exceed the overall limits under qualified plans.

These cost-of-living adjustments would be subject to the general rules relating to participation, vesting, benefit accrual, and funding that are applicable to qualified plans. Supplemental benefits provided under a qualified plan would be taxable under the general rules providing for tax treatment of distributions from or under qualified plans. Accordingly, these benefits generally would be includible in income when distributed by the plan. Supplemental benefits provided under a qualified defined benefit pension plan may be guaranteed by the PBGC.

Cost-of-living adjustments may also be provided in a nonqualified supplemental welfare plan if the plan meets certain standards prescribed by the Department of Labor. Under the Department of Labor standards, the plan must provide that (1) payment is made for the purpose of supplementing the pension benefits of a participant out of the general assets of the employer or a separate trust fund established and maintained solely for that purpose, (2) the maximum amount payable generally cannot exceed a percentage of the employee's retirement benefit equal to the increase in the Consumer Price Index, and (3) the payment may not be made before the last day of the month with respect to which it is computed. If a supplemental plan meets these requirements, it is treated as a welfare plan rather than a pension plan. Welfare plans are not subject, under ERISA, to the minimum standards relating to participation, vesting, benefit accrual, and funding. In addition, these benefits are not guaranteed by the PBGC.

Benefits provided under a nonqualified supplemental plan that meets the Department of Labor standards are taxable when paid if they are paid out of the general assets of the employer. If the benefits are paid out of a separate earmarked trust fund, generally the value of the benefits would be includible in income when the employee's right to the benefits is not subject to a substantial risk of forfeiture (Code sec. 83). Under a nonqualified supplemental plan, no employer deduction is permitted for contributions to the plan until the benefits are includible in income of the employee.

Issues

The issues are (1) whether employers should be further encouraged to provide cost-of-living adjustments for pension benefits and (2) the level of security that should be provided to employees with respect to such adjustments.

Explanation of the Bill

The bill would provide that a defined contribution plan maintained by an employer does not fail to satisfy the requirements for tax qualification merely because the plan includes a "qualified supplemental benefit arrangement." The latter term would be defined to mean an arrangement that supplements the retirement benefit to which an employee is entitled under one or more defined benefit pension plans of the employer (the "primary retirement benefit") and that meets certain other requirements.

The bill would require that if a qualified defined contribution plan provides a qualified supplemental benefit arrangement, the arrangment must be available to any participant in a defined benefit pension plan of the employer who (1) is employed by the employer at the time the individual attains the earliest age at which the primary retirement benefit may be paid or becomes disabled and (2) is entitled to a primary retirement benefit at that time. In addition, the arrangement must permit an eligible participant to elect to purchase an individual or group annuity contract (including a guaranteed investment contract or similar arrangement) from an insurance company licensed to do business under the laws of any State. Under the bill, the election must be provided in the earlier of (1) the year in which the participant attains normal retirement age and retires or (2) the year in which payment of the primary retirement benefit begins. Payments under the annuity contract may not begin earlier than the year after the year in which the election is made.

Under the bill, the amount of the qualified supplemental benefit must be computed as a percentage of the participant's primary retirement benefit. The bill would permit the employer and participant to share the cost of the annuity in any proportion. In no event, however, could the portion of the supplemental benefit attributable to employer contributions exceed the greater of (1) three percent of the primary retirement benefit or (2) a percentage of the primary retirement benefit equal to a seven-year average of the cost-of-living increase (determined using the appropriate Consumer Price Index or other comparable index selected by the Treasury Department).

The bill would provide that a qualified supplemental benefit arrangement would not be discriminatory if the classification of employees eligible to benefit under the arrangement satisfies the general rules relating to coverage of employees under a qualified plan (Code sec. 410(b)). Pre-retirement vesting in benefits under a qualified supplemental benefit arrangement would not be required and no accrual of the benefit would be required until the employee attains the earliest age at which retirement benefits may be paid or the employee becomes disabled. Accordingly, an employee who severs employment with the employer before retirement age would not be entitled to the qualified supplemental benefit. Qualified supplemental benefits would not be guaranteed by the PBGC.

If the supplemental arrangement is part of a profit-sharing plan, the bill would permit an employer to make contributions to the arrangement contingent upon profits for the year. If no employer contributions are made for a year, an employee who elected to participate in the arrangement for the year would be entitled to a refund of employee contributions. In addition, the employee would be entitled to participate, in any year in which the employer makes contributions, before any employee who made the election to participate at a later date.

Under the bill, contributions of the employer or the employee to a qualified supplemental benefit arrangement are not treated as annual additions for purposes of the overall limits on contributions and benefits. An employer would be allowed a deduction for contributions to a qualified supplemental benefit arrangement without regard to the usual limits on deductions for contributions to a qualified plan.

The tax treatment of benefits under a qualified supplemental benefit arrangement would be determined under the general rules relating to the tax treatment of benefits under qualified plans. Thus, in general, the benefits would not be includible in income until they are distributed.

Effective Date

In general, the bill would be effective for taxable years beginning after December 31, 1982. The provision of the bill relating to the overall limits on contributions and benefits under qualified plans would be effective for years (within the meaning of Code section 415) beginning after December 31, 1982.

2. S. 1550 — Senators Chafee, McClure, and Grassley

Treatment of Foreign Income Taxes on Certain U.S. Construction Contract Services

Present Law

U.S. treatment of foreign taxes—in general

U.S. persons[1] are taxable on their worldwide income, including their foreign income. U.S. taxpayers have a choice between two methods of treating foreign income taxes on their U.S. returns.[2] Taxpayers may (1) deduct foreign income taxes from taxable income, or (2) take full, dollar-for-dollar, credit for foreign income taxes.

The foreign tax credit is limited so that it may reduce U.S. tax on foreign income, but not U.S. tax on U.S. income. Taxpayers may not mix methods during any one year; i.e., a taxpayer who chooses to credit any foreign income taxes may not deduct any other foreign income taxes that year. [3]

Taxpayers generally must deduct, and cannot credit, foreign taxes (like excise taxes or property taxes) that are not income taxes.

Foreign tax credit

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not offset U.S. tax on domestic income.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax any or all of the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to prevent double taxation.

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[1] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

[2] Foreign income taxes include income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country (or possession of the United States).

[3] In most cases, taxpayers prefer a reduction of U.S. tax over a reduction of taxable income. Therefore, most taxpayers elect the foreign tax credit, and do not deduct foreign income taxes. Sometimes, however, a deduction is more helpful than a credit. A taxpayer whose return shows a net operating loss can increase that loss by deducting foreign taxes. The taxpayer may be able to deduct that net operating loss in a later year. That taxpayer could not benefit from a foreign tax credit, at least in the year of the loss (taxpayers may carry excess foreign tax credits back for two years and forward for five).

Some countries avoid double taxation by exempting foreign-source income from tax altogether. However, most countries, including the United States, avoid double taxation through a foreign tax credit system, providing a dollar-for-dollar credit against home country tax liability for income taxes paid to a foreign country.

A credit is also provided for a tax paid in lieu of a foreign income tax which is otherwise generally imposed (Code sec. 903).

Foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, a statutory formula limits the foreign tax credit to insure that the credit will offset only the U.S. tax on the taxpayer's foreign income. This limitation tends both (1) to prevent other countries from taxing the U.S. tax base, and (2) to discourage U.S. taxpayers from operating in countries that tax the U.S. tax base. Without the limitation, U.S. taxpayers who paid enough high foreign taxes might operate tax-free in the United States. U.S. taxpayers would tend to become indifferent to high foreign tax rates, because the U.S. Treasury would absorb the foreign tax burden.

The limitation operates by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into two categories—U.S.-source taxable income and foreign-source taxable income.[4] Computing the limitation involves finding the ratio of foreign-source taxable income to total (pre-credit) taxable income. This fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income. This amount is the upper limit on the foreign tax credit.

The following example illustrates the computation of the foreign tax credit limitation. Assume that the U.S. taxpayer has foreign-source taxable income of $300 and U.S.-source taxable income of $200 for total taxable income of $500. Assume further that the pre-credit U.S. tax on the $500 is $230 (i.e., a 46-percent rate). Since 60 percent ($300/$500) of the taxpayer's total worldwide taxable income is from foreign sources, the foreign tax credit is limited to $138, or 60 percent of the $230 pre-credit U.S. tax. Thus, a taxpayer with foreign taxes paid in excess of $138 will only be allowed a foreign tax credit of $138 (the excess taxes paid may be carried to other years) and if the taxpayer has paid less than $138 in foreign taxes he will have a foreign tax credit equal to the amount of the taxes paid.

Taxpayers may credit any country's income tax so long as total foreign income—whether or not from that country—is high enough. Thus, one country's high tax may offset U.S. tax on income from a country that imposes no tax or a low tax. This is an "overall" limitation.

A taxpayer may credit taxes that foreign countries impose on U.S. income if total foreign income is high enough.

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[4] The pre-credit U.S. tax is the U.S. tax before all credits, that is, before the investment tax credit and other credits as well as the foreign tax credit.

Source of income — U.S. or foreign

For the foreign tax credit mechanism to function, every item of income must have a source, that is, it must arise either within the United States or without the United States. A source rule is important because the United States acknowledges that foreign countries have the first right to tax foreign-source income, but the United States insists on imposing its full tax on U.S.-source income.

The United States treats compensation for personal services performed in the United States as U.S.-source income (sec. 861(a)(3)). This income is U.S.-source income even though the person paying for the services resides in a foreign country and uses the services in a foreign country. For example, payments for a blueprint drawn in the United States for use in a foreign country are U.S.-source income. (If that foreign country taxes those payments, those taxes may be creditable income taxes, but a U.S. recipient with excess foreign tax credits cannot credit them. The taxpayer will be able to credit these foreign income taxes only if he or she has enough income from foreign sources that is subject to foreign tax at less than the U.S. rate.)

The United States Model Income Tax Treaty (which represents the U.S. negotiating position) and the Model Treaty of the Organization for Economic Cooperation and Development adopt the U.S. statutory rule that only the country where the services are performed may tax this income (Article 7 (Business Profits), Article 14 (Dependent Personal Services), and Article 15 (Independent Personal Services)). Most developed countries use this rule.

Some foreign countries, especially developing countries, have a tax source rule different from the U.S. rule, however. They treat income from personal services as having its source in the country where the services are used. Generally, in a developing country, the total value of services used is greater than the total value of services performed. A place-of-use source rule therefore gives a developing country a broader tax base than a place-of-performance source rule. Like the United States, these countries will insist on taxing income from sources within their borders. These countries also insist on using their own source rules. Therefore, these countries and the United States insist on taxing the same income. Double taxation arises.

The United States has few treaties with developing countries. However, under the income tax treaty between the United States and Morocco, payments from the Government of Morocco to a U.S. person for technical and economic studies have their source in Morocco (Articles 5(3) and 12(3)(c)). Payments from the private sector to U.S. persons for services for use in Morocco still have their source in the United States.

Problem of excess foreign tax credits

Under the U.S. rules described above, U.S. taxpayers may pay more foreign income taxes than they can credit on their U.S. tax returns. Such taxpayers have "excess foreign tax credits."

Excess foreign tax credits can arise for a variety of reasons. A principal reason is foreign tax rates that are higher than the U.S. rate. Another reason is that U.S. losses may reduce worldwide income and thus creditable foreign taxes. Another reason is that foreign countries include in their tax bases more income than the United States would. "Base-broadening" by foreign countries can take various forms, such as the denial of deductions that U.S. law would allow. Another form of base-broadening arises when a foreign country taxes income that the United States considers U.S. income—when the two countries disagree about the source of income.

The inability to credit some taxes while deducting others

The reason that Congress requires taxpayers either to deduct all foreign taxes or to credit all foreign taxes is that allowing a deduction for the amount of taxes not credited would reduce the U.S. tax rate on U.S. source income. H. Rept. No. 708, 72d Cong., 1st Sess. 11-12 (1932). If both a credit and deduction were allowed, "preferential treatment would frequently be given to taxpayers receiving income from foreign sources." *Id.* at 12. For example, assume that a taxpayer has $100 income from a foreign country and $200 domestic source income, and has paid a tax of $80 to the foreign country. The limitation is 100/300 of $138 (46% tax on $300) or $46. There is then an excess foreign tax of $34. If this $34 is then deducted from the $300 total taxable income, the tax before credit is reduced to $122 (46% of $266). After crediting $46 of the foreign tax, the United States tax is $76. Since a 46% tax on the domestic source income of $200 is $92, the deduction has reduced the tax on domestic source income.[5]

Foreign taxation of payments for technical assistance

Many countries impose gross withholding taxes on payments for technical services (such as engineering services, architectural services, and other construction contract services) that a U.S. taxpayer performs in the United States for use within their borders.[6] Some countries waive or reduce these taxes in negotiations with foreign taxpayers on a case-by-case basis. Others reduce them through tax treaties. The United States treats these gross taxes as creditable income taxes (Treas. Reg. sec. 4-901-2(e), Example 31; Proposed Reg. sec. 1-903).[7] Therefore, a taxpayer who elects the foreign tax credit cannot deduct these taxes. Certain gross withholding taxes imposed on receipts of nonresidents with limited contacts in a country have become an internationally accepted form of taxation.

Impact of foreign taxes on construction service industry

Creditable taxes on income of a U.S. taxpayer who performs services in the United States for use in a foreign country present a problem if the taxpayer has excess foreign tax credits. That taxpayer will not be able to credit them because of the excess credits, and will generally not be able to deduct them because of the U.S. rule that a taxpayer must either credit all foreign income taxes or deduct all foreign income taxes. These taxes may also create a problem of excess foreign tax credits for a taxpayer, because the income to which they relate is not foreign income under the U.S. rules. That is, that income does not increase the foreign tax credit limitation.

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[5] This example comes from E. Owens, *The Foreign Tax Credit* 290 (1961), but reflects the reduction in the corporate tax rate since that time.

[6] Proponents of S. 1550 have listed several countries that impose such taxes: Algeria, Argentina, Brazil, Chile, People's Republic of China, Colombia, Ecuador, Indonesia, Korea, Malaysia, Mexico, New Zealand, Panama, South Africa, Spain, Tanzania, Thailand, and Venezuela.

[7] If a U.S. taxpayer performs services for a foreign government that taxes those services, however, the taxpayer may contend that it does not fully qualify as an income tax and that it should be, at least in part, a deduction that reduces U.S. taxable income.

Examples

The following examples show the interaction, under current law, of (1) foreign taxes on U.S.-source income and (2) the foreign tax credit limitation. The first example shows the inability of a taxpayer with excess foreign tax credits to absorb foreign taxes on income that the United States considers to arise here. The second example shows that a taxpayer *without* excess foreign tax credits can absorb foreign taxes on income that the United States considers to arise here.

Example 1 — Excess foreign tax credits

Assume that a taxpayer who is subject to U.S. tax at a 46-percent rate earns $100 of net income for performing services in country A for use there. Country A imposes a 60 percent net income tax on the taxpayer. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B. This $30 of net income consists of $100 of gross income reduced by $70 of expenses. Country B imposes a 20-percent withholding tax on the gross $100 payment. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income.

Under current law, if the taxpayer elects the foreign tax credit, the taxpayer would owe $13.80 of U.S. tax, computed as follows:

Table 1

Taxpayer With Excess Credits

	A	B	Total
(1) Foreign income	$100	$0	$100
(2) U.S. income	0	30	30
(3) Worldwide income			130
(4) U.S. tax before FTC			59.80
(5) Foreign tax	60	20	80
(6) FTC limitation			46
(7) Credit allowed (lesser of (5) or (6))			46
(8) U.S. tax ((4)–(7))			13.80

By taking the credit, the taxpayer would also have $34 of excess foreign tax credits available for carryback or carryover.

If the taxpayer, under current law, deducts foreign taxes, he or she would have taxable income of $50 ($130 of pre-foreign-tax income less $80 of foreign taxes). At a 46-percent U.S. rate, the taxpayer would owe U.S. tax of $23. Thus, in such circumstances, the taxpayer would elect the credit (and pay U.S. tax of $13.80) and forego the deduction for foreign taxes (which would cause U.S. tax of $23).

Example 2 — No excess foreign tax credits

Assume the facts are the same as in Example 1, except that Country A has a 25-percent tax rate (instead of a 60-percent rate). If the foreign tax credit is elected under current law, the taxpayer would owe U.S. tax of $14.80, computed as follows:

Table 2

Taxpayer Without Excess Credits

	A	B	Total
(1) Foreign income	$100	$0	$100
(2) U.S. income	0	30	30
(3) Worldwide income			130
(4) U.S. tax before FTC			59.80
(5) Foreign tax	25	20	45
(6) FTC limitation			46
(7) Credit allowed (lesser of (5) or (6))			45
(8) U.S. tax ((4)−(7))			14.80

If the foreign taxes are deducted under current law, the taxpayer would have taxable income of $85 ($130 of pre-foreign-tax income less $45 of foreign taxes). At a 46-percent U.S. rate, the taxpayer would owe U.S. tax of $39.10. In such circumstances the taxpayer would elect the credit (and pay U.S. tax of $14.80) and forego the deduction (which would cause U.S. tax of $39.10).

DISC

The Internal Revenue Code provides income tax deferral on up to ~~57.5~~ 42.5 percent of the income of a Domestic International Sales Corporation (disc), a special purpose corporation that exports goods or services. Income from engineering or architectural services for construction projects located (or proposed for location) outside the United States is eligible for DISC treatment, whether or not the U.S. taxpayer performs the services in the United States.

Explanation of the Bill

In general

S. 1550 would allow taxpayers to elect (1) to deduct any foreign country's income taxes on construction contract services performed in the United States for use in the foreign country and (2) to credit other foreign income taxes. The income taxes that a taxpayer could elect to deduct include income taxes that are otherwise creditable under the Internal Revenue Code.

The bill would define construction contract services to mean engineering, architectural, design, project management, procurement, cost estimating, scheduling, construction planning, or construction mobilization services, or other services, including financial, administrative, clerical, data processing or reproduction services, which are related and subsidiary to any of those services.

A taxpayer would make the election to deduct taxes on construction contract services on a country-by-country basis, so that the taxpayer could credit one country's taxes on construction contract services while deducting another country's similar taxes that year. A taxpayer could not, of course, credit any taxes that he or she elected to deduct under this provision.

A taxpayer would make these country-by-country elections on an annual basis. This election, like the election to credit foreign taxes, could be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of tax for the taxable year. The Internal Revenue Service has taken the position that, for the election to credit foreign taxes, that period generally expires three years after filing of the return for that taxable year (Reg. sec. 1.901-1(d)). The U.S. Court of Claims has held, however, that the period expires ten years after the filing deadline for the taxable year.[8]

The election to deduct a country's taxes on construction contract services would not be allowed if the Secretary of the Treasury finds that under the laws of a foreign country, citizens of the United States or U.S. corporations are being subjected to a higher effective rate of tax than are nationals, residents, or corporations of any other countries with respect to income from construction contract services. That is, taxes on income imposed by a country that discriminated against the United States would not be eligible for the election under the bill. However, a foreign country could grant favorable treatment to a third country in an income tax treaty without violating this non-discrimination rule.

Interaction with foreign tax credit limitation

General rule

In general, a taxpayer with excess foreign tax credits would make the election under the bill, while a taxpayer that did not have excess foreign tax credits would not make the election.

Example 1—Excess foreign tax credits

In Example 1 (set forth above under Present Law), Country A imposes a $60 tax on $100 of Country A income. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B, on which Country B imposes a $20 tax. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income. By electing the credit, the taxpayer owed $13.80 of U.S. tax.

Under the bill, the taxpayer in example 1 would elect to deduct taxes from country B, while crediting country A's tax. The foreign tax credit would eliminate the taxpayer's U.S. tax liability on income from country A, and the taxpayer would have $14 of excess foreign tax credits available for use in other years.[9] The taxpayer would deduct the $20 country B tax from the $30 of net pre-foreign tax U.S. source income, leaving U.S.-source taxable income of $10. The taxpayer's U.S. tax would be $4.60. Thus, the taxpayer would pay less U.S. tax by making the election ($4.60) than by crediting all foreign taxes up to the limit ($13.80 of U.S. tax).

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[8] *Hart* v. *United States*, 585 F.2d 1025 (Ct. Cl. 1978)).

[9] If the taxpayer later generates low taxed foreign income, he or she could revoke the bill's election and use the greater excess foreign tax credit carryovers available for crediting all foreign taxes.

Example 2—No excess foreign tax credits

In Example 2 (set forth above under Present Law), Country A imposes a $25 tax on $100 of Country A income. The taxpayer also earns $30 of net income for performing engineering services in the United States for use in country B, on which Country B imposes a $20 tax. Thus, the taxpayer has $100 of net foreign income, and $30 of net U.S. income. By electing the credit, the taxpayer owed $14.80 of U.S. tax.

If the taxpayer made the election that the bill would provide, he or she would owe $21 of U.S. tax on income from Country A (the pre-credit U.S. tax of $46 less the $25 foreign tax credit). The taxpayer would also owe $4.60 of U.S. tax on the $10 of net income for services used in Country B. This $25.60 total U.S. tax is greater than the $14.80 U.S. tax under current law, so the taxpayer would not make the election under the bill.

Issues

Foreign tax burden on U.S. construction service businesses

The principal issue the bill presents is whether the U.S. Treasury should absorb some of the foreign tax burden of some U.S. businesses that perform construction services in the United States for use overseas. The bill could improve the ability of some U.S. businesses to compete against foreign businesses.

Proponents of the bill indicate that the tax laws of some industrialized countries (like Holland, Germany, Canada, and the United Kingdom) permit deduction of taxes that lesser developed countries impose on income from construction contract services. These countries consider income from services to arise where the services are performed. Companies in these countries can use their foreign tax credit for foreign income taxes on foreign-source income, while deducting foreign income taxes on domestic-source income. Other countries (like Korea, and France and Switzerland by treaty) treat that income as foreign source, and allow a credit for the taxes under their credit mechanism. U.S. companies, by contrast, may be subject to double taxation, so they cannot easily compete directly with foreign companies, but can do so only by operating in foreign countries through foreign subsidiaries. To the extent that U.S. businesses forego producing services for use in foreign countries, the United States loses jobs. If these foreign taxes are seen only as a cost of doing business abroad, they should be deductible. On the other hand, the proposal could make U.S. tax law more favorable than the tax laws of the countries (United Kingdom, Holland) that allow deductions for foreign tax imposed on domestic source income. Few, if any, of those countries allow taxpayers the choice of crediting such taxes. In addition, in some cases, U.S. law is already more generous than that of other countries by allowing an overall foreign tax credit limitation rather than a per-country limitation.

The bill departs from traditional U.S. tax concepts that require taxpayers either to deduct or to credit all foreign taxes. Whenever a taxpayer has U.S.—source income and credits some foreign taxes, deducting foreign taxes in excess of those creditable reduces the U.S. tax on U.S. income. This results in preferential treatment for taxpayers with foreign source income.

In some cases, the bill could allow foreign countries (1) the sole right to tax foreign income, and (2) the first right to tax U.S. income. As for foreign income, when a U.S. taxpayer has excess foreign tax credits, foreign countries already have the sole right to tax—the United States does not tax foreign income when foreign taxes are higher than U.S. taxes on that income. As for U.S. income, under the bill, a foreign country might appear to have the first right to tax. The United States would allow a deduction for foreign taxes on U.S. income, while the foreign country would not have to allow a deduction for U.S. tax on the same U.S. income. That is, the U.S. tax base is net income (after foreign tax), while the foreign tax base is generally gross income (before U.S. tax). Arguably, however, some foreign countries may impose gross withholding taxes at relatively low rates to take account of the disallowance of all deductions, so that the United States and the foreign country would have comparable rights to tax U.S. income.

Effect on foreign country taxation

A related issue is whether the approach taken in the bill would affect activity of foreign countries. On the one hand, enactment could encourage foreign countries where services are used to enact or to increase taxes on income from construction contract services. On the other hand, these countries may not be able to increase their tax rates without slowing the development they seek. Moreover, U.S. companies are not the only suppliers of construction services—tax increases in countries where services are used could force withdrawal of non-U.S. companies. Some countries would be reluctant to impose taxes so high as to drive away suppliers of services. Other countries may raise taxes to encourage local production of technical services. In any event, the bill would not apply to countries that use internal law to discriminate against U.S. enterprises.

Scope of bill's application

The scope of the bill's application presents a further issue. Construction services may produce the vast bulk of U.S. source income that other countries now tax. Computer services, attorneys' and accountants' services, and the like, may be of minor importance. The application to taxes on construction services income, moreover, may be proper because taxpayers can sometimes arrange to perform construction contract services in a particular location for tax reasons, while other kinds of income are not so easy to shift. Therefore, special rules to encourage performance of construction contract services in the United States may be proper. Moreover, construction contract services jobs may be more important to the United States than most other jobs, because use of U.S. construction contract services may frequently cause the user to buy U.S. exports. In addition, the United States may not be able to afford to let other countries surpass it in this field. The DISC rules that provide special treatment for income from architectural and engineering services (and for exports in general) for foreign use may be inadequate in this case. The DISC rules do not prevent double taxation, and those rules do not cover many of the services that the bill covers.

Other issues

Other issues involve whether other solutions to the problem of excess foreign tax credits are available. Arguably, Treasury or the taxpayers involved should pressure the foreign governments involved to conform their source rules to ours. It is unclear that such pressure would have any effect. Another approach would be to change the U.S. source rule so that at least part of certain types of services income have their source in the country where the services are used. This rule would allow the country where the services are used the first right to tax those services. A change in the source rules could have a greater revenue impact than that of the bill, and would be a departure from the approach of many developed countries. Another approach would be to require a company to elect the bill's treatment for all countries or for none during a given year, or to require companies to elect this treatment for periods longer than one year.

Revenue impact

The bill's revenue effect turns on whether U.S. businesses are now incurring taxes on income from construction contract services that they cannot credit. If so, the bill could bring work into the United States and thus increase revenues. If not, the proposal would create a revenue loss. The choice of a business situs involves a number of factors. Companies may now choose to perform work in the United States for business reasons, even though a U.S. location means a higher tax burden. Alternatively, tax planning may dominate the choice of where to perform construction contract services.

Effective Date

The bill would apply to taxable years ending after December 31, 1982.

3. S. 1557 — Senators Chafee and Bentsen

Exemptions from U.S. Tax for Interest Paid to Foreign Persons

Present Law

In general

The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from the United States or abroad (in the case of foreign source income, however, a dollar-for-dollar credit is allowed for any foreign income tax paid). Nonresident aliens and foreign corporations, however, are generally taxed on only their income which is from U.S. sources.

Withholding tax on foreign investors

In situations where the U.S.-source income received by a nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income.

If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business of the foreign investor, that income is not subject to the flat 30-percent withholding tax on gross income, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

The tax law provides a number of exemptions from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business and similar institutions is exempt (secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (secs. 871(a)(1)(A) and (C) and 881(a)(1) and (3)). Any interest and dividends paid by a domestic corporation which earns less that 20 percent of its gross income from sources within the United States (an "80/20 company") is also exempt from the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Also, interest on certain debt obligations which were part of an issue with respect to which an election had been made for purposes of the expired Interest Equalization Tax is exempt (secs. 861(a)(1)(G) and 4912(c)).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is generally exempt from U.S. tax (sec. 892). Treasury regulations deny the exemption for income which the foreign government receives from commercial activities in the United States or income which inures to the benefit of any private person. Although interest received by a foreign government might not qualify for the statutory exemption for foreign governments, that interest might be eligible for other exemptions (such as that available for interest on bank accounts).

There is no estate tax liability with respect to a debt obligation or a bank deposit yielding interest that would not be subject to the 30-percent withholding tax if the decedent received it at the time of his death (secs. 2104 and 2105). In addition, individuals who are neither citizens nor domiciliaries of the United States are not subject to estate tax liability with respect to stock or debt obligations of a foreign corporation. There is no estate tax liability in the case of an obligation of a U.S. corporation's foreign finance subsidiary, or in the case of a foreign corporation established to hold U.S. assets.

Tax treaty exemptions

In addition to the statutory exemptions listed above, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons. The exemption or reduced rate applies only if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States.

It is generally the negotiating position of the United States, as expressed in Article 11 of the Treasury's model income tax treaty, to exempt interest from withholding unless the income is effectively connected with a permanent establishment or fixed base. The treaty exemption is based on the assumption that the interest income will be taxed in the country of residency in any event.

Interest generally is exempt under treaties with Austria, Denmark, Finland, West Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, the U.S.S.R., and the United Kingdom. Reciprocal reductions in rate are provided under treaties with Belgium, Canada, Egypt, Morocco, and the Philippines (15 percent), Jamaica and Malta (12.5 percent), Korea (12 percent), France, Japan, and Romania (10 percent), and Switzerland (5 percent). Under some treaties, only certain interest (such as bank interest or interest on public debt) is exempt.

Treaty shopping.—Although the treaty exemptions are intended to benefit only residents of the treaty country, it has been possible, as a practical matter, for investors from other countries to obtain the benefits of those treaties providing an exemption from U.S. tax on U.S. source interest income. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaty with the United States to a reciprocal exemption of interest (e.g., Canada and France), can effectively secure the exemption by lending money through a country having a treaty with the United States that contains the interest exemption. The foreign investor does this by establishing a subsidiary, trust, or other investing entity in the treaty country which makes the loan to the U.S. person and claims the treaty exemption for the interest it receives.

If the investment entity is established in an appropriate country, it may be possible for the investing entity in turn to pay the interest to the foreign investor or to a tax haven entity without any tax liability to the recipient. The tax deduction in the treaty country for this payment may eliminate or minimize the investing entity's tax liability. This use of U.S. tax treaties by third country investors to avoid any tax on the interest income rather than to avoid a potential double tax is referred to as "treaty shopping." As discussed below, a more important treaty shopping use of U.S. tax treaties is the use by U.S. corporations of the U.S. treaty applicable to the Netherlands Antilles (and, in a few cases, other treaties) to obtain an exemption from U.S. tax on interest paid to foreign investors on bonds issued by the U.S. corporations through Antilles (or other country) finance subsidiaries.

In the last two years, the United States has given unilateral notice of termination of income tax treaties with nineteen countries and territories. The treaties were extensions of treaties between the United States and the United Kingdom and Belgium. Many of these treaties, before termination, offered treaty shopping opportunities for third country investors.

In 1981, the Senate returned to the President a proposed treaty with the British Virgin Islands that would have allowed, like the U.S.-BVI treaty then in force, use by third country investors. In 1982, the United States gave notice of termination for the income tax treaty with the British Virgin Islands that was then in force. This notice occurred after the Treasury Department had found potential for tax abuse in the operation of that treaty.[1]

In June 1983, the United States terminated the income tax treaties with Anguilla, Barbados, Belize, Burundi, Dominica, Falkland Islands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Sierra Leone, Zaire, and Zambia. There was also potential for third country residents to use many of these treaties.

Compliance with tax liability on interest income

U.S. payors are generally required to file information returns to report the payment of interest (including original issue discount) of $10 or more. Nominees are generally required to file reports with respect to interest received and passed along to the beneficial owners. One copy of the return is required to be sent to the recipient of the interest and another copy is sent to the Internal Revenue Service.

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[1] A discussion of treaty shopping involving that treaty appears in Vogel, Berstein & Nitsche, "Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise?" 34 Tax L. Rev. 321, 360 (1979).

Returns are generally required for amounts paid on corporate indebtedness. However, no information reporting is required in the case of interest paid to (or original issue discount accruing for) foreign investors if withholding tax is imposed on the payment or if withholding tax would be imposed but for an exemption from withholding either because the amounts are eligible for a treaty exemption or the exemption for deposits with banks or because they are effectively connected with a U.S. trade or business, or if certain other limitations apply.

The Code generally disallows the interest deduction (and a reduction in earnings and profits) to the issuer of corporate debt that is in bearer form. Generally, it also generally either imposes an excise tax on the issuer of bearer debt or disallows capital gains treatment or a loss deduction to the holder of bearer debt. In general, the requirement that obligations be registered does not apply if they are issued under arrangements reasonably designed to insure that they are sold only to persons who are not United States persons and the interest on the obligations is payable only outside the United States and its possessions. In addition, a statement must appear on the face of the obligation to indicate that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws. These rules were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

To the extent an obligation is subject to withholding on amounts paid to a foreign investor, such interest is not subject to back-up withholding (sec. 3406(b)(1)). Back-up withholding applies at a rate of 20 percent to any reportable interest payment paid or credited at a time when the payor has no taxpayer identification number (TIN) for a payee or has been notified that the TIN supplied by the payee is incorrect, or that the payee has failed to report an amount of interest or dividend income, or the payee has failed to certify that he is not subject to backup withholding (when required to do so).

As described above, withholding is generally required when interest is paid to a foreign investor. The Code (secs. 1441(c)(2) and 1442(a)) authorizes the Treasury to require this withholding in any situation in which the beneficial owner of securities on which the interest is paid is unknown to the withholding agent. This authority has been exercised generally to require withholding in all such situations (Treas. Reg. sec. 1.1441-3(c)(4).) In addition, Form 1042S must be provided by the withholding agent to the payee when amounts have been withheld.

In order to secure a treaty exemption or reduction from U.S. withholding tax on U.S.-source interest income, a foreign resident must file (or the resident's trustee or agent receiving the interest income must file on his behalf) IRS Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). Form 1001 requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the form must be presented to the payor by or on behalf of the foreign owner with each coupon. TEFRA requires the Treasury to establish procedures for insuring that treaty benefits are available only to persons entitled to them. The Treasury could, for example, require recipients to certify their residence or to claim refunds for tax automatically withheld.

Even where the foreign investor presenting an interest coupon on a corporate bond is not entitled to a treaty rate reduction or exemption, the foreign investor is nevertheless required to present, with each such coupon, a certificate of ownership on Form 1001. (The information required by that form is described above.) Where the owner of the bond is unknown to the person presenting the coupons for payment, the regulations further provide that the first bank to which the coupons are presented for payment is to require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee (Treas. Reg. sec. 1.1461-1).

Background

Eurobond market

A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions who market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies—see discussion below), foreign governments and government agencies, and other borrowers.

In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market for the bonds with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities sold in the Eurobond market are free of taxes withheld at source, and the form of bond, debenture, or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premiums, and principal net of any tax which might be withheld at source (subject to a right of the issuer to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). U.S. multinational corporations issue bonds in the Eurobond market free of U.S. withholding tax through the use of finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles. Foreign issuers offer bond issues not subject to withholding tax in their home jurisdiction either through foreign finance subsidiaries (e.g., Germany, at least in the case of financings for use outside Germany) or through specific statutory exemptions.

In some cases, the statutory exemptions apply to interest paid to foreign investors generally (e.g., the Netherlands and Sweden) or, more frequently, the exception is contingent on the bond being issued in a foreign currency (e.g., Japan). Because the Eurobond market is comprised of bonds not subject to withholding tax by the country of source, an issuer could not easily compete for funds in the Eurobond market if its interest payments were subject to withholding tax.

Unlike bonds issued in the U.S. capital market, Eurobonds are issued in bearer (rather than registered) form so that the interest and principal payments must be effected by presenting the coupons or bonds to a designated paying agent. Since the bonds are issued in bearer form, the anonymity of the holder of the bond is protected—the holder's identity is not disclosed to the issuer or to the government of the country of issue.

International finance subsidiaries

When U.S. corporations borrow abroad (such as on the Eurobond market), they generally do so through the use of finance subsidiaries. Finance subsidiaries are usually paper corporations without employees or fixed assets which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The interest and principal on the bonds issued by the finance subsidiary are guaranteed by its parent. The use of finance subsidiaries (described below) is intended to avoid any U.S. withholding taxes on the interest paid to the foreign bondholders.

The type of corporation used will depend, in part, on the intended use of the proceeds. If a corporation seeks money for use abroad, it will sometimes form a special U.S. finance subsidiary—an "80/20 company"—through which it issues bonds. As noted earlier, even though the borrower (the finance subsidiary) is a U.S. corporation, interest paid by it to foreign lenders will be treated as foreign source income, and hence will not be subject to withholding, if less than 20 percent of the finance subsidiary's gross income is from U.S. sources. This gross income requirement usually is met if the U.S. finance subsidiary invests the borrowed funds in the foreign operations of the corporate group.

The most common practice of borrowers, particularly those seeking funds for use in the United States, is to establish a finance subsidiary in the Netherlands Antilles.[2] This structure is designed to avoid the U.S. withholding tax by claiming the benefits of the tax treaty between the United States and the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders, and the subsidiary then relends the borrowed funds to the parent or to other affiliates within the corporate group.

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[2] Taxpayers have also pursued the establishment of finance subsidiaries in three U.S. possessions: Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands. The United States does not impose withholding tax on payments of interest, dividends, and other passive income to corporations organized in those possessions. Those possessions generally use the Internal Revenue Code as their territorial income tax law by substituting the name of the possession for the words "United States" as appropriate. These "mirror code" rules include the "80/20" source rule that interest and dividends paid by a corporation organized in the possession are not possession source income if less than 20 percent of the corporation's income is from sources in the possession. A possession subsidiary whose sole activity is lending money to its (non-possession) U.S. parent, according to some taxpayers, would earn only non-possession source income. Therefore, taxpayers have contended that payments of interest and dividends from such a corporation to a foreign investor are free of possession withholding tax. (No other finance subsidiary device claims this treatment for dividends.) Temporary Treasury regulations, however, indicate that income derived from one of these possessions that is not subject to tax to the recipient there is U.S. source income. Under the mirror concept, then, income derived from the United States (such as interest paid from a U.S. corporation to a Guamanian finance subsidiary) that is not subject to U.S. tax to the recipient (because of the U.S. rule exempting such income from tax) is possession source income. Therefore, the 20 percent rule does not apply, and the possession must impose a 30 percent withholding tax on payments from the finance subsidiary to the foreign investor.

The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates). Alternatively, the subsidiary's indebtedness is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the cash proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

Pursuant to Article VIII of the treaty, an exemption is claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary consists of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary.

Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no U.S. "second-tier" withholding tax would be imposed (sec. 861(a)(1)(C)).[3] Thus, no tax is paid on the interest paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles. Use of a foreign subsidiary may also increase the parent's ability to utilize foreign tax credits, because the net income of the subsidiary will be foreign source income in the hands of the parent. It will be currently taxable under the anti-tax haven type activity rules of Subpart F.

Borrowings by U.S. corporations in the Eurobond market occurred originally as a result of a program adopted by the U.S. Government during the 1960s at a time of fixed exchange rates. The program, designed to prevent the devaluation of the dollar, included several measures to encourage U.S. companies to borrow overseas, including the Interest Equalization Tax, the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, a relaxation of the no-action letter policy of the Securities and Exchange Commission with respect to foreign offerings by U.S. corporations, and the ruling policy of the IRS which encouraged foreign borrowings through finance subsidiaries. In the case of finance subsidiaries, domestic or foreign, the IRS was prepared to issue private rulings that no U.S. withholding tax applied if the ratio of the subsidiary's debt to its equity did not exceed 5 to

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[3] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

1 and certain other conditions were met. Numerous private rulings were issued on this basis. Finance subsidiaries were also sanctioned by a number of published rulings.[4] Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces—with the consequent termination of these measures to support the dollar—Eurobond offerings by U.S. corporations decreased. This decrease was in large part due to questions as to whether finance subsidiaries qualify for the exemption from the U.S. withholding tax, questions which arose when the IRS, citing the expiration of the IET, revoked its prior rulings that properly structured finance subsidiaries would qualify (Rev. Rul. 74-464, 1974-2 C.B. 46).

Because of a finance subsidiary's limited activities, the lack of any significant earning power other than the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of the bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required.[5] (This risk would appear to increase where, as is sometimes the case, the bonds are convertible into stock of the parent.)

Alternatively, the creation of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent with the result that the exemption might not apply (Code sec. 269). Nevertheless, these finance subsidiary arrangements do in form satisfy the requirements for an exemption from the withholding tax and a number of legal arguments would support the taxation of these arrangements in accordance with their form. In any event, notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, many bond issues have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.[6]

In recent years, however, field agents of the IRS have challenged certain arrangements involving Antilles finance subsidiaries.[7] The outcome of these challenges is not yet clear.

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[4] Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 72-416, 1972-2 C.B. 591; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231.

[5] Compare, e.g., *Aiken Industries, Inc.,*, 56 T.C. 925 (1971) and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. Paragraph 9494, *cert. denied*, 406 U.S. 1076, with *Moline Properties*, 319 U.S. 436 (1943), 43-1 U.S.T.C. Paragraph 9464 and *Perry R. Bass*, 50 T.C. 595 (1968).

[6] For detailed discussions of Eurobond financings through finance subsidiaries and of the legal issues presented, see Povell, "International Finance Subsidiaries Under Attack", in Practising Law Institute, Foreign Tax Planning 1983 9 (1983); Lederman, "The Offshore Subsidiary: An Analysis of the Current Benefits and Problems", 51 Journal of Taxation 86 (August 1979); and Chancellor, "Eurobond Financings", U. So. Cal. Tax Inst. 345 (1971).

[7] According to one source, there have been challenges to at least 25 of these arrangements. See 46 Taxes International 13 (August 1983). One company, Texas International Airlines, has disclosed such an audit in a proxy statement. Failka, "Closing a Loophole," Wall Street Journal, Oct, 11, 1982, at 17, col. 2.

The United States and the Netherlands Antilles are now in the process of renegotiating the existing treaty. The representatives of the Antilles in these negotiations have sought to continue treaty shopping benefits available in the current treaty on the ground that the United States needs the "financial pipeline" that the Antilles provide.[8]

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Table of interest paid and tax withheld

The following table shows portfolio interest and withholding on that income for 1981, based on information returns filed with the Internal Revenue Service. The information is arranged according to the payee's country of address, which is not necessarily his country of residence.

Portfolio Interest Paid to Foreign Recipients and U.S. Tax Withheld—1981

(Millions of dollars)

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Bahamas	3.4	0.1	0.9	0.9	11.4
Belgium	24.2	.7	3.3	3.5	13.6
Bermuda	19.2	.6	5.0	5.2	26.0
Canada	487.3	14.5	34.6	36.3	7.1
France	180.5	5.4	8.7	9.1	4.8
West Germany	192.0	5.7	.4	.4	.2
Hong Kong	4.6	.1	.8	.8	17.4
Italy	14.2	.4	.9	.9	6.3
Japan	158.2	4.7	7.3	7.7	4.6
Luxembourg	20.4	.6	.5	.5	2.5
Mexico	6.5	.2	1.1	1.2	16.9
Netherlands	200.1	5.9	.5	.5	.2
Netherlands Antilles	1,037.0	30.8	1.4	1.5	.1
Panama	11.5	.3	1.3	1.4	11.3
Saudia Arabia	207.5	6.2	(1)	(2)	(2)
Sweden	8.5	.3	.1	.1	1.2
Switzerland	349.2	10.4	15.9	16.7	4.6

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[8] See Fialka, "Closing a Loophole," Wall Street Journal, Oct. 11, 1982, at 17, col. 2.

Portfolio Interest Paid to Foreign Recipients and U.S. Tax Withheld—1981—Continued

(Millions of dollars)

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
United Arab Emirates	1.6	(2)	(1)	(2)	(2)
United Kingdom	326.0	9.7	1.7	1.8	.5
Other countries	112.9	3.4	10.8	11.3	9.6
Total	3,364.7		95.3		2.8

[1] Less than $50,000.

[2] Less than one-tenth of 1 percent.

Source: Internal Revenue Service, Foreign Returns Analysis Section.

Prior Congressional Action

In connection with its consideration of the Tax Reform Act of 1976, the House Committee on Ways and Means voted to repeal the 30-percent withholding tax on both interest and dividends. However, the House of Representatives removed this provision from the bill by a vote of 301-119. The Senate Committee on Finance proposed an amendment which would have repealed the 30-percent tax on interest only. However, this amendment was deleted from the bill on the Senate floor by a vote of 54-34.

In 1979, the Senate Committee on Finance reported H. R. 2297, repealing the U. S. withholding tax on portfolio interest paid to foreign lenders, but the Senate did not act on that bill.

In 1980, the House Committee on Ways and Means held hearings on a similar bill, but did not take further action on it.

Explanation of the Bill

Withholding tax

Under S. 1557, interest paid by a U. S. borrower on three categories of debt instruments ("assumed debt", "bearer debt", and "registered debt") would generally be exempt from U. S. tax (under Code secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation.

The first category of exempt interest is interest paid on certain obligations assumed by U.S. corporations after the date of enactment ("assumed debt"). For the interest to be exempt, the U.S. corporation must have assumed an obligation that was issued on or before the date of enactment. When originally issued, the later-assumed obligation must have been guaranteed by a U.S. corporation and must have been sold pursuant to arrangements reasonably designed to ensure that it would be sold (or resold in connection with the original issue) only to non-U.S. persons. The exemption of interest in this category generally allows U.S. corporations that assume debt of Netherlands Antilles financing subsidiaries to pay tax-exempt interest on that debt. Many contractual arrangements among U.S. borrowers, Netherlands Antilles financing subsidiaries and foreign lenders contemplate assumption by the U.S. borrower in the event of repeal of the 30-percent U.S. tax. The proposal would also generally allow U.S. corporations that assume debt of "80/20" companies to use the proceeds of those borrowings to generate U.S. source income.

The second category of exempt interest is interest on certain obligations not in registered form, i.e., payable to the person who has physical possession of the paper debt instrument ("bearer debt"). For the interest to be exempt, there must be arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons, the interest must be payable only outside the United States and its possessions, and on the face of the obligation there must be a statement that any United States person who holds it will be subject to limitations under the United States income tax laws. This exemption would apply to the debt of any U.S. issuer, not just to debt of U.S. corporations. Therefore, it would apply to obligations of the United States and its agencies.

The third category of exempt interest is interest on an obligation in registered form if the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) has received a statement that the beneficial owner of the obligation is not a U.S. person ("registered debt"). The statement must either (1) purport to be from the beneficial owner of the obligation or (2) actually be from a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business. The statement would not have to identify the owner, but simply to state that the owner was not a U.S. person. The Secretary of the Treasury would have authority to publish a determination to the effect that statements from a securities clearing organization, bank, or other financial institution, or any class of such persons, are not adequate to qualify an obligation for this category. Interest paid more than one month after publication of a notice of inadequacy would be subject to the 30-percent tax, and the agent paying interest in such a case would have a duty to deduct and withhold U.S. tax. This exemption, like the bearer debt exemption, would apply to the debt of any U.S. issuer.

Not all interest on instruments in these three categories would be exempt from U.S. tax. Interest would not be entitled to the exemption from U.S. tax if it were effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus would be taxed at the regular graduated rates. Also, otherwise exempt interest on bearer debt or registered debt would not be exempt if paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the capital or profits interest of the partnership.

Foreign banks would generally not be entitled to the exemption for interest they received on either bearer debt or registered debt on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. Foreign banks would, however, be exempt from U.S. tax on interest paid on bearer or registered obligations of the United States.

To prevent U. S. persons from indirectly taking advantage of this exemption, the bills provide that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the exemption for interest on bearer debt or registered debt received from U. S. persons.

Interest on assumed debt would be free of U.S. tax even in the hands of foreign persons having direct ownership interest in the U.S. payor, in the hands of a foreign bank, or in the hands of controlled foreign corporations.

Estate tax

The bill would also eliminate any potential U. S. estate tax liability of nonresident alien individuals, in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

Prevention of tax evasion

The bill would provide that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to prevent evasion of taxes, the exemption would no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination would continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on debt obligations.

Under the bill, an explicit duty to deduct and withhold would arise only if the person otherwise subject to the duty knows, or has reason to know, that the income is taxable because the recipient is related to the payor or because the recipient is a foreign bank. There would be no duty to withhold on payments to controlled foreign corporations. The bill would not affect the authority of the Secretary of the Treasury to require a payor to withhold in cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid. The present regulations require withholding where the ultimate recipient of the interest is unknown.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

Issues

Capital formation

Foreign placements of U.S. corporate bonds have increased from $4.4 billion in 1980 to $14.6 billion in 1982. During this period, international bond issues rose from 10 to 28 percent of total public debt placements by U.S. corporations.[9] This increase in international bond issues has been facilitated by the use of Netherland Antilles subsidiaries which sell bonds, guaranteed by the U.S. parent corporation, to foreign investors free of the U.S. withholding tax. Some argue that repeal of the withholding tax would increase the inflow of capital to U.S. corporations allowing financing at lower rates and larger domestic investment.

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[9] Morgan Guarantee Trust Co., "World Financial Markets," (August 1983) p. 17.

However, U.S. corporate bonds sold in the Eurobond market comprise only a small portion of total U.S. assets held by foreign investors. At the end of 1981, U.S. assets abroad totaled $557.1 billion, including $10.7 billion of corporate bonds, $64.6 billion of corporate equity, $125.1 billion of U.S. government bonds, $209.5 billion of deposits in United States banks, and $89.8 billion of direct investments.[10]

Proponents of the bill argue that repeal of the 30-percent withholding tax on interest would increase the attractiveness of medium term U.S. bonds to foreign investors. (There appears to be no significant market for long-term bonds outside the United States.) This in turn would likely result in an increased inflow of capital and a change in the type of U.S. assets held by foreign investors. If the primary effect of repeal is to cause a shift from shorter to longer term securities in the portfolio of U.S. assets held abroad and little or no net capital inflow, then the long term interest rate would tend to decline. This could benefit the U.S. economy by stimulating investment in plant and equipment, and could benefit foreign investors who would prefer to hold longer term U.S. government and corporate securities.[11]

Another possible consequence of the bill is that some foreigners who are now investing in bonds denominated in foreign currencies will switch to dollar-denominated bonds of U.S. corporations or the Treasury. This too should reduce long term interest rates in the United States. However, this net capital inflow would strengthen the dollar and have an adverse impact on the U.S. trade balance (see below).

A third consequence of repeal would be to reduce foreign purchases of stripped Treasury bonds (and other exotic securities) to the extent that foreign investors' demand for these securities is influenced by the withholding tax.

Employment and trade balance

Currently, the United States follows a policy of flexible exchange rates under which the market is allowed to set the value of the dollar relative to other currencies based on supply and demand, rather than having the government attempt to peg the value of the dollar at a particular level. In a regime of flexible exchange rates, net capital inflows strengthen the dollar. A stronger dollar reduces the dollar price of imports into the United States and makes our exports more expensive to the foreign purchasers. Thus, it tends to reduce our exports and increase imports. Consequently, if repeal of the withholding tax increases net capital flows into the United States, there will be a corresponding reduction in net exports (exports minus imports). On balance, there is likely to be no net increase in employment; instead there is likely to be a shift of employment from export oriented sectors to capital intensive sectors within the United States. A stronger dollar also could aggravate the international debt crisis by making it more difficult for debtor countries to repay their dollar denominated debts.

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[10] Bureau of Economic Analysis, "Survey of Current Business," (August 1982) p. 45, Table 3.

[11] A similar shift in the relationship between long-term and short-term interest rates would be achieved by reducing the maturity of Treasury debt issues.

These possible adverse impacts of repeal of the withholding tax are likely to be transitory. As time passes, payments of interest to foreigners will tend to depress the value of the dollar to its prerepeal level. However, given the problems posed by the present high value of the dollar, some argue that even a temporary appreciation of the dollar should be avoided.

Control of money supply

Opponents of the repeal of the 30-percent withholding tax have argued that to the extent that international capital mobility is increased by repeal, the federal reserve system will lose a degree of control over the money supply. Proponents, on the other hand, assert that in an environment of flexible exchange rates, capital mobility does not reduce control of the domestic money supply but instead influences the exchange rate. They argue that international capital mobility actually increases the efficacy of domestic monetary policy.

Efficiency of world capital markets

Forward and futures markets in international currencies do not generally trade in maturities of longer than one year. Thus medium term U.S. corporate and government bonds are attractive to foreign investors desiring to hedge against depreciation of their home currencies relative to the dollar for a period longer than one year. The 30-percent withholding tax may limit such hedging activity and as a result reduce the efficiency of the world capital market. Proponents of repeal of the withholding tax argue that the loss in efficiency is large relative to the revenue raised by the tax. They also point out that the cost of operating Netherland Antilles financing subsidiaries, including taxes paid to the Antilles government, could be avoided if the withholding tax were repealed. Since the withholding tax raises little revenue and imposes significant efficiency costs on the U.S. economy, proponents argue that it should be repealed.

Opponents assert that the use of Netherland Antilles corporations may not be eliminated by repeal of the withholding tax because of other tax planning purposes served by these subsidiaries apart from the avoidance of the withholding tax (e.g., absorption of excess foreign tax credits). However, there may be other ways to achieve those planning purposes, and it is unclean whether many Netherlands Antilles finance subsidiaries would be used in the future.

Revenue impacts

Those in favor of repeal of the withholding tax on interest argue that there are already so many exceptions to the withholding tax that there is little point in retaining the tax in the few situations to which it does apply. In 1981, for example, only $95,336,000 was withheld on $3,364,728,000 of portfolio interest paid to foreign taxpayers, an effective rate of 2.8 percent. Proponents of repeal argue that the repeal of withholding in the few remaining cases where it is applicable will relieve taxpayers from complying with considerable administrative burdens where the tax is not applicable and would be an important simplification.

The Treasury Department has estimated that the bill would increase revenues by $35 million to $50 million annually. This estimate presupposes that enactment of the bill would cause U.S. taxpayers to claim less foreign tax credits than they would if the bill were not enacted. The estimate is based on a number of assumptions, three of which are noteworthy. First, Treasury's estimate assumes that the U.S. taxpayers and their Nethelands Antilles finance subsidiaries claiming benefits under the Netherlands Antilles treaty are entitled to those benefits. That is, the estimate assumes that the Netherlands Antilles finance subsidiary arrangement is valid for U.S. tax purposes. Second, Treasury's estimate assumes that U.S. taxpayers are paying creditable income taxes to the Netherlands Antilles. Third, the estimate assumes that U.S. parents of Netherland Antilles finance subsidiaries will dissolve those subsidiaries upon enactment of the bill. Proponents of the bill, using these three assumptions and a similar analysis, have suggested that the revenue gain from enactment could exceed Treasury's estimate.

It is not clear, however, that it is appropriate to attribute a revenue increase to this legislation, because it is not clear that the bill would cause taxpayers to claim less foreign tax credits than they otherwise would be entitled to. First, it is not clear that Eurobond issues by U.S. companies would continue in the future (absent legislation). The progress of audits of Netherlands Antilles finance subsidiary arrangements in the ordinary course of administrative practice could cause future offerings to decrease or even to stop. Similarly, if Treasury ruled that it would not in the future treat new Eurobond issues as qualifying under the treaty, it is doubtful that any new offerings would occur. In either event, the bill could cause a substantial revenue loss. Second, it is not clear to what extent the taxes that the Netherlands Antilles imposes on finance subsidiaries are income taxes that are properly creditable rather than taxes on capital. If these taxes are not creditable, the bill would not reduce proper claims of foreign tax credits. Third, the bill would not compel liquidation of Netherlands Antilles finance subsidiaries. Therefore, if U.S. parent corporations wanted to continue use of this arrangement, they could do so. Some U.S. corporations might keep these subsidiaries in place, because they take the view that these subsidiaries generate creditable low-taxed foreign source income that enables the U.S. parent to credit other foreign taxes. If the Netherlands Antilles finance subsidiary arrangement is valid for tax purposes, then enactment of the bill would not prevent continued generation of low-taxed foreign source income and claims of foreign tax credits.

In any event, to the extent that enactment of the bill would attract additional foreign capital to the United States, it would increase the interest deductions of U.S. taxpayers. There would be no U.S. tax on the interest income (in the hands of the foreign lender) that corresponds to this interest deduction, however. This lack of a corresponding income inclusion would tend to reduce U.S. revenues.

Equity arguments

Opponents of repeal argue that it would be inequitable to exempt foreign lenders from tax on U.S. source interest income while continuing to tax interest received by U.S. lenders. In their view, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since the U.S. borrowers reduce their U.S. tax by deducting the interest payments.

Proponents of repeal counter that the correct comparison is not with the U.S. treatment of U.S. lenders but with the way in which other foreign countries treat lenders from outside their borders since these rules determine the environment in which U.S. borrowers must compete for funds. Proponents point out that many other countries provide mechanisms for the issuance of Eurobonds free of withholding tax. Proponents claim that the equity argument is superficial because, in their view, foreign lenders will not pay U.S. tax on U.S. source interest income even if the United States continues to impose it; they will instead merely invest elsewhere. Moreover, they note that few foreign lenders pay U.S. tax today.

Tax avoidance and evasion

Opponents argue that if no withholding tax is imposed on interest by the country of the borrower, it would greatly increase the flow of movable capital to tax havens and bank secrecy jurisdictions, with the result that no tax would be paid on the interest to any country. In addition, because of the difficulties of enforcement, at least some of these tax-free bonds would probably be held by U.S. persons evading U.S. tax. Opponents of repeal argue that withholding at source is the only effective way to prevent tax avoidance and evasion. It is argued that repeal of withholding would undercut the long-term efforts of the United States to curb international tax evasion and avoidance, and to encourage other countries to assist in that effort. Those favoring repeal argue in response that there presently are virtually unlimited opportunities for taxpayers to evade taxes if they intend to do so and that repeal of the U.S. withholding tax on U.S. corporate bonds is unlikely to cause anyone to evade or avoid taxes who would not do so in any event. Moreover, they argue that the present method of access to the Eurobond market shows U.S. approval of complex schemes that allow the sophisticated to avoid tax.

Treaty negotiations

Opponents also argue that repeal of the withholding tax would result in the surrender of a valuable "bargaining chip" available to our tax treaty negotiators. That is, if investors residing in a foreign country would be subject to a 30-percent tax unless their country entered into a tax treaty with the United States, then their government would have a greater incentive to enter into a tax treaty to eliminate the tax. The United States could insist on a reciprocal concession as the price of such a provision. In that regard, opponents of repeal note that 36.3 percent of the revenue (as shown in the table) is from Canada, which recently has refused in treaty negotiations to agree to a reciprocal reduction of withholding rates on interest below 15 percent. Moreover, an additional 24.4 percent of the revenue is from Switzerland and Japan, which also have refused to reciprocally reduce withholding rates on interest to zero. Thus, more than three-fifths of the revenue loss resulting from unilateral repeal would merely be a transfer to the Treasuries of those countries or a windfall for investors from these four countries. If the investor was in a low tax bracket (or failed to report the income in his home country), repeal would most benefit the investor. Otherwise, absent repeal, those countries' foreign tax credit mechanisms would absorb some or all of the U.S. tax.

On the other hand, those favoring repeal argue that reliance on reciprocal rate reductions or exemptions in tax treaties is arbitrarily discriminatory in the area of portfolio investment. Proponents of repeal further argue that, even if the withholding tax were repealed, other countries would still have an incentive to enter into treaties with the United States to reduce double taxation of income other than portfolio interest and to eliminate fiscal evasion. This is particularly true if, as in the case of the bill, the repeal is targeted so that it does not generally apply to interest paid to related parties or banks. In addition, many foreign countries might prefer not to encourage their investors to export capital to the United States.

Treaty shopping

Proponents of the repeal of the tax argue that present law has a much more deleterious effect on the tax treaty program than the loss of any possible advantages that the tax may have as a bargaining chip. In order to attract needed foreign investment, they argue, the United States must permit U.S. corporations to issue tax free Eurobonds through finance subsidiaries in the Netherlands Antilles. This approval of the use of treaties by third-country nationals encourages other "treaty shopping" abuses of our tax treaty network.

Proponents of repeal argue that it would allow the United States to take a much more aggressive position in rengotiating the treaty with the Netherlands Antilles. They argue that the main benefit the United States derives from the treaty is access to the Eurobond market. They contend that if the bill passes, the United States will have much less reason to concede matters of substance to the Antilles in those negotiations. Specifically, the United States will have little or no reason to agree to the treaty shopping arrangements the Antilles seek for Antilles corporations beneficially owned by third country residents.

Moreover, they argue, the use of finance subsidiaries to accomplish essentially the same result as repeal of the withholding tax is unnecessarily complex and expensive to the corporations issuing the bonds. Their use is expensive to the U.S. Treasury since the taxes paid to the Antilles by the finance subsidiaries are claimed by their U.S. parents as foreign tax credits.

Opponents respond that the treaty shopping abuses of the Netherland Antilles and other treaties can be eliminated by simply revising the treaties—that if the problem is the avoidance of U.S. tax through abuses of U.S. tax treaties, repeal of the tax would not be a sensible solution to that tax avoidance.

Foreign tax credit

Opponents of repeal also point out that if the foreign investor is from a high tax country, he generally will be allowed a foreign tax credit for the withholding taxes paid to the United States and therefore the repeal of withholding will not provide any greater return to him which would give him a greater incentive to invest in the United States. Instead there would only be a transfer from the U.S. Treasury to his home country's treasury.

On the other hand, proponents of repeal point out that if the investor is from a low-tax country, repeal of withholding generally would make a difference to him. Also, there are significant accumulations of wealth held by pension trusts in developed countries which may be entirely exempt from foreign tax. In this case, repeal of U.S. withholding would also provide a positive incentive to invest in the United States. Opponents argue, however, that there is no reason not to target the elimination of U.S. tax to limited classes of foreign persons through a narrow Code amendment or through a reciprocal treaty exemption. Also, depending on the mechanism his foreign country has adopted for estimated tax payments, a foreign investor may lose the use of the amount withheld for the period between the time the U.S. tax is withheld on the interest and the time he can secure a credit from his government. Opponents of repeal also argue that if the 30 percent rate is too high, then some reduction of that rate rather than elimination of the tax is appropriate. They argue foreign investors will generally care about the strength of the dollar and the U.S. economy. They argue that even if combined with elimination of treaty shopping opportunities, repeal would have little effect on foreign demand for U.S. debt.

Foreign banks

Under present law and Treasury regulations, foreign banks are subject to the regular U.S. corporate income tax on income that is effectively connected with a U.S. trade or business. If is it not effectively connected, they are subject to the 30-percent U.S. gross withholding tax (unless a treaty rate reduction of exemption applies). Repeal of the withholding tax on assumed debt would make it possible for foreign banks to receive interest payments on assumed debt without payment of either the regular corporate tax or the withholding tax. This tax exemption, together with their exemption from reporting requirements and reserve requirements applicable to U.S. banks and extended to U.S. branches of foreign banks, could provide to these foreign banks operating from offshore a competitive advantage over U.S. banks and U.S. branches of foreign banks.

Withholding tax as a protective tariff

Proponents of repeal of the 30-percent withholding tax argue that the attractiveness of U.S. bonds in the international bond market is greatly diminished by the withholding tax, so that the tax is a barrier to international trade in assets. The marketability of U.S. bonds abroad is limited to the extent that foreign bondholders, in non-treaty countries, are unable to claim credit for the U.S. withholding tax. This is the case for foreign tax exempt entities such as foreign pension funds and bondholders in an excess credit position. Also many foreign investors are reluctant to claim the credit because anonymity of ownership is sacrificed.

Opponents of repeal assert that the United States grants foreign jurisdictions the same right to tax interest income at its source and allows a credit for withholding taxes paid by domestic lenders. Furthermore, the United States Treasury position has been to bilaterally reduce or eliminate the withholding tax in treaty negotiations. Opponents view the tax as comparable to, and in lieu of, the income tax imposed on U.S. lenders. The tax is not designed to discourage foreign persons from buying U.S. government and corporate bonds but merely to subject them to a tax comparable to the tax paid by U.S. bondholders. They believe it would be inappropriate to eliminate the tax merely because it reduces the marketability of domestic bonds to foreign investors seeking to avoid taxation in their home countries.

Optimal rate of the withholding tax

Some opponents of repeal make the point that a lower-rate withholding tax might raise substantially more revenue than the current 30-percent tax. They argue that above a certain tax rate (less than 30 percent) collections from the withholding tax fall off because of the greater incentive for tax avoidance. This "Laffer curve" analysis suggests that the withholding tax rate should be lowered to the point at which revenue collections of the Treasury are maximized (i.e., the tax rate should be set equal to the marginal cost of tax avoidance). Such a revenue-maximizing tax might be in the range of 5 or 10 percent and probably would have to be accompanied by the closing of the Netherland Antilles "window."

Foreign policy aspects

As previously noted, one of the principal methods for the avoidance of U.S. withholding taxes on corporate obligations is the use of Netherlands Antilles finance subsidiaries. This results in considerable financial activity in the Antilles. The Antilles government has argued against repeal of the general withholding requirement in the Code on the ground that it would no longer be necessary to route borrowings through the Antilles, and the use of the Antilles as a financial center would be substantially reduced. Offshore financing activities generate a large portion of the Antilles budget. To insure the stability of the Antilles, the United States might find it advisable to replace a considerable part of these taxes with foreign aid.

Proponents of repeal point out, however, that the need to route transactions through the Antilles adds needlessly to the cost of borrowing. The same business that now generates jobs in the Antilles could be used to generate more financial jobs in the United States. Because of the availability of the foreign tax credit, some of the revenues collected by the Antilles may in effect already come out of the U.S. Treasury through reduction of the U.S. tax burden on the U.S. parent of an Antilles finance subsidiary. Further, proponents of repeal argue that it is illogical from a foreign policy standpoint for the U.S. contribution to a Caribbean country's economy to be determined by that year's volume of Eurobond offerings.

Disclosure requirements

In its consideration of similar legislation in the 96th Congress, the Senate Finance Committee report made it clear that it intended that information reporting requirements remain in effect with respect to interest exempt from withholding tax. In addition, the Committee report indicated the intention that the Treasury use its authority to require withholding where the payor of the income does not know the owner of the securities on which the interest is paid. The Committee report made it clear that this authority was to be used to ensure the collection of tax where interest is paid to direct investors or CFC's.

Those who oppose an interest reporting requirement contend that it does not comport with the realities of the Eurobond marketplace and therefore would nullify any beneficial effect of the repeal of withholding. They point out that the Eurobonds issued by competing borrowers from other countries do not require withholding, are free of reporting requirements, and are typically in bearer, rather than registered, form. A requirement that the lender report his identity to qualify for exemption from withholding would impose an administrative burden on lenders and could also raise some doubt in the minds of the lenders as to whether the obligations in their hands qualified for exemption from withholding. Those arguing that there should be no disclosure requirements for obligations that generally yield tax-free income argue that the loss of anonymity would make it impossible, as a practical matter, to market the obligations of U.S. borrowers to those foreign investors who are unwilling to have their identities disclosed to the IRS. They argue that the U.S. Treasury would have less difficulty in preventing evasion of U.S. tax by U.S. taxpayers if U.S. borrowers could issue debt directly, rather than through the Netherlands Antilles. They contend that strict Antilles bank secrecy laws now make it difficult to determine the ultimate beneficial owner of debt issued by financing subsidiaries.

Those who support the information reporting requirements argue that, without these rules, it would be simple for direct investors and foreign subsidiaries to avoid the limitations on the exemption from withholding. It would be possible, although difficult, to track down interest income paid to foreign subsidiaries through the Internal Revenue Service audit process. Many U.S. shareholders of CFCs would never be audited. It would generally not be possible to audit foreign direct investors. Additionally, those supporting reporting requirements argue that their absence would assist U.S persons to evade U.S. tax by investing anonymously in bearer obligations abroad. They argue further that the principal reason foreign holders of bearer bonds would refuse to disclose their identities to the IRS is that they are evading taxes and currency control requirements of their own countries. They argue further that a decision by the United States not to require the reporting of the identity of the beneficial owner in order to increase the marketability of bonds issued by U.S. companies would be contrary to the U.S.

policy not to condone foreign fiscal fraud and contrary to the spirit of our tax treaty exchange of information obligations.

Foreign subsidiaries (controlled foreign corporations)

The bill does not generally provide an exemption for interest paid to controlled foreign corporations (CFCs)[12] on the grounds that there are a number of ways in which such an exemption could result in undue tax advantages. However, the bill does exempt CFCs from U.S. tax on assumed debt—debt assumed by U.S. corporations after the bill's effective date.

If CFCs could receive interest income free of withholding tax, U.S. tax on that income could be deferred indefinitely, if the CFC also had an active business. Alternatively, if the U.S. parent had excess foreign tax credits from unrelated foreign business operations, the interest could in effect be repatriated to the parent tax-free. Finally, even if neither of these fact patterns applies and the interest income of the foreign subsidiary is currently taxable to the U.S. parent under subpart F without being fully offset by foreign tax credits, the U.S. parent could benefit by being able to invest pre-tax dollars in U.S. debt obligations rather than only the amount remaining after imposition of U.S. tax. Each of these possibilities is explained in greater detail below.

In the case of a controlled foreign corporation (CFC), subpart F (Code secs. 951-64) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income, including interest income. However, no inclusion is required if these types of income amount to less than 10 percent of the gross income of the corporation. Most corporations with active businesses abroad are eligible for this exception because the *gross* income from their business activity is generally more than 90 percent of total gross income even though their net investment income may be a larger proportion of their overall net income because of greater expenses associated with the active conduct of a business.

Advantages could exist for the U.S. shareholder of a CFC even if the shareholder were required to report the interest income currently. For example, suppose that a U.S. parent company has excess foreign tax credits.[13] If the U.S. parent lent money directly to a U.S. borrower, the U.S. parent would, of course, be taxable on the interest income. However, if the U.S. parent makes an investment (such as buying assumed debt) through a foreign subsidiary (a

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[12] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

[13] The United States taxes domestic taxpayers on their worldwide income, but allows a credit against its tax for foreign income taxes. The credit allowable in any year is limited, however, by a formula which is generally intended to allow the foreign tax credit to offset only the U.S. tax on the taxpayer's foreign source income, not the tax on its U.S. source income. Generally, the limitation is equal to the taxpayer's pre-credit U.S. tax multiplied by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. A taxpayer whose foreign income taxes are greater than this limit is said to have excess tax credits. The excess credits may be carried back 2 years and forward 5 years to be utilized in years in which the taxpayer's foreign tax credit limitation formula exceeds foreign income taxes actually paid. However, if the excess credits cannot be used in any of these years, they are lost forever. Many taxpayers find that, because of high foreign tax rates, they are chronically in an excess credit position.

CFC), the U.S. parent may, in effect, receive the income tax-free. The U.S. source interest income could (absent U.S. withholding) be received by the subsidiary free of U.S. tax. The only tax paid by the subsidiary would be the tax imposed by the country in which it is received, which may be considerably lower than the U.S. tax rate paid by the parent.[14] When this interest income of the subsidiary is taxed to the U.S. shareholder under subpart F as an actual or constructive dividend, the dividend may be treated as foreign source income, because the CFC is a foreign corporation, even though the interest income received by the CFC was from U.S. sources. Thus, U.S. source income (the interest) may in effect be converted into foreign source income (the dividend). This increases the U.S. shareholder's foreign tax credit limitation and may permit the taxpayer to use its excess foreign tax credits from its unrelated foreign active business operations (which might otherwise expire unused) to offset completely its U.S. tax on the income, allowing the U.S. interest income to be received without imposition of any U.S. tax.

A U.S. shareholder of the CFC may obtain tax advantages from repeal of the withholding tax even if the shareholder is not in an excess foreign tax credit position. If the CFC has accumulated earnings abroad which are not subpart F income, it could not repatriate them without causing its U.S. shareholder to pay U.S. tax on the dividend income.[15] The U.S. shareholder could then reinvest only the after-tax amount of the dividend in obligations of U.S. companies. However,if the income is not repatriated, the CFC could invest the pre-tax amount of earnings (which, if foreign income taxes are low, could be considerably larger than the amount which would remain after U.S. tax) in obligations of U.S. companies. Thus, although the U.S. parent would be subject to to current U.S. tax on the interest income earned by the foreign subsidiary under subpart F (unless the 10-percent de minimis rule described earlier applied), the subsidiary would have had a larger amount available to invest, and thus would receive more income, than the U.S. parent would have had if the funds had been repatriated to it as a dividend. This could be attractive if the subsidiary were not also burdened with a withholding tax on interest received. While this would be attractive even where the higher amounts of interest income of the CFC are currently taxable to the U.S. parent under subpart F, it is particularly attractive where, on account of the 10-percent de minimis rule, the interest is not subpart F income taxable to the U.S. parent.

Those who favor extending the repeal of the withholding tax to all interest paid to CFCs point out in this last situation that discouraging the CFC from investing in debt of U.S. obligors is contrary to the policy expressed by Congress in the Tax Reform Act of 1976. Prior to the amendments made by that Act, U.S. shareholders of CFCs were treated as receiving a dividend from the CFC whenever the CFC invested in the "U.S. property," including debt obligations of U.S. persons. This rule was adopted because it was felt that reinvestment of the funds in the U.S. was a repatriation essentially equivalent to a dividend. However, the 1976 Act changed this rule to permit portfolio investment in the United States without imposition of current tax under subpart F. Thus, CFCs were no longer encouraged by subpart F to reinvest earnings abroad, rather than in the United States. It was believed that this would improve the U.S. balance of payments in encouraging capital inflow from CFCs into the United States. Proponents also point out that, if a U.S. withholding tax is imposed on interest received by a CFC, and the U.S. tax on dividends from the CFC is not eliminated by the foreign tax credit, double taxation of the income will result. That is, the income will be taxed once by the United States when paid to the CFC and will be taxed a second time when paid as a dividend by the CFC to the U.S. shareholder. Proponents of the bill's approach argue that it leaves CFCs where they are under current law, because CFCs can now invest in obligations of Netherlands Antilles finance subsidiaries of U.S. corporations without incurring the U.S. withholding tax.

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[14] If the tax paid on the interest to the foreign country in which it is received is at least equal to the U.S. rate of tax, then the parent would have no incentive based on this analysis to structure the loan through the foreign subsidiary. However, if it did so, the parent would still pay no U.S. tax, so that net result would be a transfer of funds from the U.S. Treasury to the foreign country's treasury.

[15] This assumes that the U.S. shareholder would not be entitled to an indirect foreign tax credit (for taxes paid by the CFC on its income) which would eliminate U.S. tax on the dividend.

4. S. 1666 — Senators Chafee, Bentsen, Durenberger, Boren, Wallop, and Pryor, and others

"Capital Formation Tax Act of 1983"

Present Law

General rule

Under present law, gain or loss from the disposition of a capital asset which has been held for more than one year receives special tax treatment. Capital assets generally include property (including corporate stock) held by the taxpayer other than property held for sale to customers and property used in the taxpayer's trade or business. In addition, gain from the disposition of property used in a trade or business, in excess of depreciation recapture, may be treated as gain from the sale of a capital asset.

Noncorporate capital gains tax

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. (Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain is 20 percent, i.e., 50 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain includible in adjusted gross income.

Capital losses of noncorporate taxpayers are deductible against all capital gains and against up to $3,000 of ordinary income in each year. In determining the amount of capital losses which may be deducted from ordinary income, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be taken into account. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Corporate capital gains

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. The highest regular corporate tax rate is 46 percent for taxable income over $100,000.

Small business corporation stock

Present law generally does not distinguish between stock of different corporations for purposes of determining the treatment of capital gains or losses on disposition of the stock.

However, under Code section 1244, losses on the disposition of certain small business corporation stock by an individual taxpayer may be treated as ordinary, rather than capital, losses. (These losses may then be deducted in full against the taxpayer's ordinary income.) This provision applies to up to $1 million of common stock issued by a qualified small business corporation more than 50 percent of whose gross receipts for its five most recent taxable years must be derived from the active conduct of a trade or business. A maximum of $50,000 ($100,000 in the case of a joint return) of ordinary loss from the disposition of qualified stock may be claimed in any taxable year.

Issues

The principal issue is whether capital gain from the disposition of stock acquired through certain initial stock offerings should be taxable at a specially reduced rate. If it is determined to apply such a reduced rate, a related issue concerns the period for which the taxpayer must hold the stock before the reduced rate will apply.

Explanation of the Bill

The bill would provide that for noncorporate taxpayers, 80 percent of net capital gain attributable to the disposition of qualified initial issues of stock, if such stock was held by the taxpayer for at least five years, would be deductible from gross income. Qualified initial issues would be defined to mean issues of stock which (1) are publicly or privately offered through an initial stock offering by a corporation,[1] (2) are purchased from the initial offeror, broker, or agent, and (3) represent contributions to capital or paid-in surplus of such corporation.

Thus, assuming current tax rates, the highest tax rate which would apply to such dispositions of qualified initial issues of stock would be 10 percent, i.e., 50 percent (the highest individual tax rate) times the 20 percent of allocable net capital gains includible in adjusted gross income (assuming the alternative minimum tax did not apply). Net capital gain in excess of the gain attributable to the disposition of qualified initial issue stock would continue to be taxed at a maximum 20-percent rate. The bill would not affect the tax treatment of net capital losses attributable to the disposition of qualified initial issue stock.

The provisions of the bill would not affect the tax treatment of capital gains of corporate taxpayers.

Effective Date

The bill would apply to sales and exchanges of qualified initial issue stock occurring after December 31, 1983.

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[1] It is understood that the definition of initial stock issues under the bill is not intended to be limited to the first issuance of stock by a corporation, but includes any initial stock offering (as contrasted with a secondary stock offering.)

II

98TH CONGRESS
1ST SESSION

S. 1066

To amend the Internal Revenue Code of 1954 to allow an employer to provide participants in a defined benefit plan with supplemental retirement benefits through a defined contribution plan of the employer.

IN THE SENATE OF THE UNITED STATES

APRIL 15 (legislative day, APRIL 12), 1983

Mr. CHAFEE (for himself, Mr. BENTSEN, and Mr. BAUCUS) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to allow an employer to provide participants in a defined benefit plan with supplemental retirement benefits through a defined contribution plan of the employer.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Supplemental Retirement Benefit Act of 1983".

SEC. 2. (a) Section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, stock bonus plans, etc.) is amended by inserting after subsection (1) the following new subsection:

"(m) QUALIFIED SUPPLEMENTAL BENEFIT ARRANGEMENTS.—

"(1) GENERAL RULE.—A defined contribution plan shall not fail to satisfy the requirements of this section merely because the plan includes a qualified supplemental benefit arrangement which supplements a primary retirement benefit.

"(2) PRIMARY RETIREMENT BENEFIT.—For purposes of this subsection, a primary retirement benefit means a retirement benefit which is payable under one or more defined benefit plans maintained by the same employer.

"(3) QUALIFIED SUPPLEMENTAL BENEFIT ARRANGEMENT.—For purposes of this subsection, the term 'qualified supplemental benefit arrangement' means an arrangement which is part of a defined contribution plan of an employer which supplements the primary retirement benefits and which meets the following requirements:

"(A) IN GENERAL.—The arrangement provides that—

"(i) an eligible participant in a defined benefit plan of the employer may elect, in the earlier of the year in which—

"(I) the participant attains normal retirement age and retires, or

"(II) the primary retirement benefit of the participant begins,

to purchase an annuity which commences not earlier than the year after the year in which the election is made,

"(ii) such annuity is provided through the purchase, on or before the date on which payments under the annuity begin, of an individual or group annuity contract (including a guaranteed investment contract or similar arrangement) from an insurance carrier licensed under the laws of any State to issue such contracts, and

"(iii) the employer and the participant each share a stated portion of the cost of such annuity.

"(B) ELIGIBILITY.—Each employee of the employer who—

"(i) is a participant in any defined benefit plan of the employer,

"(ii) is employed by the employer at the time the employee—

"(I) attained the earliest age at which the primary retirement benefit may be paid under the defined benefit plan, or

"(II) became disabled, and

"(iii) is entitled to a primary retirement benefit at the time described in clause (ii),

must be eligible to participate in the arrangement.

"(C) AMOUNT OF SUPPLEMENTAL BENEFIT.—Any benefit payable under the arrangement for any year is computed as a percentage of the primary retirement benefit, except that the supplemental benefit attributable to any employer contribution with respect to any participant under a qualified supplemental benefit arrangement within the meaning of section 401(m)(2) may not exceed the greater of: (i) 3 percent of the primary retirement benefit, compounded annually from the date on which the primary retirement benefit commences, or (ii) a percentage of the primary retirement benefit equal to the average cost-of-living increase (as determined using the appropriate Consumer Price Index or other comparable index, as may be selected by the Secretary) calculated over the 7 calendar years which immediately precede the commencement of the primary retirement benefit, compounded annually from the date such primary retirement benefit commences.

"(D) EMPLOYER MAY MAKE CONTRIBUTION CONTINGENT UPON PROFITS.—If the employer provides an arrangement under a profit-sharing plan, the employer may make any employer contribution for any year contingent upon profits for such year, except that any participant who elected to participate in the arrangement in the year described in subparagraph (A)(i) shall—

"(i) be reimbursed for any contribution made by him, and

"(ii) be eligible to participate in the arrangement in any subsequent year (for which profits are available) before any other participant who made such election after such participant.

"(4) APPLICATION OF DISCRIMINATION STANDARDS.—A qualified supplemental benefit arrangement shall be considered to satisfy the requirements of subsection (a)(4), with respect to the amount of contributions, so long as those employees eligible to benefit under the supplemental benefit arrangement satisfy the provisions of subparagraph (A) or (B) of section 410(b)(1).".

SEC. 3. (a) Section 415(c) of the Internal Revenue Code of 1954 (relating to limitation on defined contribution plan) is amended by adding at the end thereof the following new paragraph:

"(9) CONTRIBUTIONS TO QUALIFIED SUPPLEMENTAL BENEFIT ARRANGEMENTS.—Any contribution or addition with respect to any participant under a qualified supplemental benefit arrangement (within the meaning of section 401(m)(2)) shall, for purposes of paragraph (1), not be treated as an annual addition.".

(b) Section 404(a) of such Code (relating to deduction for contributions of an employer to an employees' trust, etc.) is amended by adding at the end thereof the following new paragraph:

"(11) SPECIAL RULE FOR CONTRIBUTIONS TO QUALIFIED SUPPLEMENTAL BENEFIT ARRANGEMENTS.—Notwithstanding the limitations under this section, there shall be allowed as a deduction for any taxable year an amount equal to the amount of the deductible employer contributions to a qualified supplemental benefit arrangement (within the meaning of section 401(m)).".

SEC. 4. (a) Except as provided in subsection (b), the amendments made by this section shall apply to taxable years beginning after December 31, 1982.

(b) The amendments made by section 3(a) shall apply to years beginning after December 31, 1982.

II

98TH CONGRESS
1ST SESSION

S. 1550

To amend the Internal Revenue Code of 1954 to relieve international double taxation of overseas construction projects of United States contractors.

IN THE SENATE OF THE UNITED STATES

JUNE 27, 1983

Mr. CHAFEE introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to relieve international double taxation of overseas construction projects of United States contractors.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ELECTION TO DEDUCT CERTAIN FOREIGN TAXES.

(a) IN GENERAL.—Paragraph 4 of section 275(a) of the Internal Revenue Code of 1954 (relating to deduction of certain taxes) is amended by inserting "(other than amounts with respect to which an election under subsection (b) has been made)" after "United States".

(b) ELECTION TO DEDUCT CERTAIN FOREIGN TAXES.—Section 275 of such Code is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) ELECTION TO DEDUCT CERTAIN FOREIGN TAXES.—

"(1) IN GENERAL.—Notwithstanding subsection (a), a taxpayer may elect to deduct the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States which is imposed in connection with construction contract services rendered in the United States which are directly related to a construction project located (or proposed for location) in such foreign country or possession.

"(2) DEFINITION OF CONSTRUCTION CONTRACT SERVICES.—For purposes of this subsection, construction contract services shall mean engineering, architectural, design, project management, procurement, cost estimating, scheduling, construction planning or construction mobilization services, or other services, including financial, administrative, clerical, data processing or reproduction services, which are related and subsidiary to any of the foregoing services.

"(3) MANNER AND TIME OF ELECTION.—

"(A) IN GENERAL.—An election under paragraph (1) for the taxable year shall be made in such manner and at such time as is provided for the election to credit foreign taxes under section 901.

"(B) DISCRIMINATORY TAXES BY FOREIGN COUNTRY.—Whenever the Secretary finds that under the laws of a foreign country, citizens of the United States or domestic corporations are being subjected to a higher effective rate of tax than are nationals, residents, or corporations of any other countries with respect to income of the kind described in paragraph (1), the election under this subsection shall not be allowed to be made.".

(c) CREDIT DISALLOWED.—Section 901 of such Code (relating to taxes of foreign countries and of possessions of the United States) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(h) CERTAIN FOREIGN TAXES DEDUCTED.—The amount of any income, war profits, and excess profits taxes deducted by a taxpayer pursuant to an election under section 275(b) shall not be allowed as a credit under subsection (a).".

SEC. 2. EFFECTIVE DATE.

The amendments made by section 1 shall apply to taxable years ending after December 31, 1982.

II

98TH CONGRESS
1ST SESSION

S. 1557

To amend the Internal Revenue Code of 1954 to repeal the 30 percent tax on interest received by foreigners on certain portfolio investments which operates as a tariff to prevent such investments from entering the United States.

IN THE SENATE OF THE UNITED STATES

JUNE 28 (legislative day, JUNE 27), 1983

Mr. CHAFEE (for himself and Mr. BENTSEN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to repeal the 30 percent tax on interest received by foreigners on certain portfolio investments which operates as a tariff to prevent such investments from entering the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF CERTAIN INTEREST.

(a) IN GENERAL.—Subsection (a) of section 871 of the Internal Revenue Code of 1954 (relating to income not connected with United States business—30 percent tax) is amended by adding at the end thereof the following new paragraph:

"(4) INCOME OF NONRESIDENT ALIEN INDIVIDUALS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a)(1) on interest (including original issue discount) received by a nonresident alien individual if—

"(A) the interest is paid on an obligation which resulted from the assumption after the date of enactment of this Act by a domestic corporation of an obligation which was issued on or prior to such date and which when issued, was guaranteed by a domestic corporation and was sold pursuant to arrangements described in section 163(f)(2)(B)(i),

"(B) the interest is paid on an obligation which is not in registered form and which is described in section 163(f)(2)(B), or

"(C) the interest is paid on an obligation which is in registered form, the United States person who would otherwise be required to deduct and withhold tax from such interest under section 1441(a) has received a statement that the beneficial owner of the obligation is not a United States person and such statement meets the requirements of subsection (g), but in the case of interest paid on an obligation described in subparagraph (B) or (C) only if (i) in the case of interest received from a corporation, the nonresident alien individual does not own, and is not considered as owning (within the meaning of subsection (h)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, or (ii) in the case of interest received from a partnership, the nonresident alien individual does not own and is not considered as owning (within the meaning of subsection (h)), 10 percent or more of the capital or profits interest in such partnership. For purposes of this paragraph the term 'registered form' has the same meaning as when used in section 163(f).".

(b) CERTAIN STATEMENTS; CONSTRUCTIVE OWNERSHIP.—Section 871 of such Code (relating to tax on nonresident alien individuals) is amended by redesignatng subsection (g) as subsection (i) and by adding after subsection (f) the following two new subsections:

"(g) CERTAIN STATEMENTS.—A statement with respect to the ownership of an obligation shall meet the requirements of this subsection if such statement represents that it is from the beneficial owner of the obligation or such statement is from a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business, and within the period ending 1 month prior to the payment of interest the Secretary has not published a determination to the effect that statements from such securities clearing organization, bank, or other financial institution, or any class of such persons, may not be accepted for the purposes of this subsection.

"(h) CONSTRUCTIVE OWNERSHIP.—Section 318(a) (relating to the constructive ownership of stock), other than paragraph (1) thereof, shall apply for the purposes of determining ownership of stock of a corporation under subsection (a)(4) and section 881(c), and similar rules shall apply for the purposes of determining ownership of an interest in a partnership under subsection (a)(4) and section 881(c). For the purposes of the preceding sentence, section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation contained therein, and stock of a corporation or an interest in a partnership owned by a person by reason of the application of section 318(a)(4) shall not, for the purposes of applying paragraphs (2) and (3) of section 318(a), be considered as actually owned by such person.".

(c) CONFORMING AMENDMENT.—Section 871(a)(1) of such Code (relating to income other than capital gains) is amended by striking out "There" and inserting in lieu thereof "Except as provided in paragraph (4), there".

SEC. 2. FOREIGN CORPORATIONS.

(a) IN GENERAL.—Section 881 of the Internal Revenue Code of 1954 (relating to tax on income of foreign corporations not connected with United States business) is amended by redesignating subsection (c) as subsection (d) and by adding after subsection (b) the following new subsection:

"(c) INCOME OF FOREIGN CORPORATIONS RECEIVED FROM CERTAIN PORTFOLIO DEBT INVESTMENTS.—No tax shall be imposed under subsection (a) on interest (including original issue discount) received by a foreign corporation if—

"(1) the interest is paid on an obligation described in section 871(a)(4)(A),

"(2) the interest is paid on an obligation described in section 871(a)(4)(B), or

"(3) the interest is paid on an obligation which is in registered form, the person who would otherwise be required to deduct and withhold tax from such interest under section 1442(a) has received a statement that the beneficial owner of the obligation is not a United States person, and such statement meets the requirements of section 871(g),

but in the case of interest paid on an obligation described in subsection (2) or (3) only if (i) the interest is not interest received by a controlled foreign corporation, (ii) except for interest paid on an obligation of the United States, the interest is not interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its banking business, (iii) in the case of interest received from a corporation, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(h)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation, and (iv) in the case of interest received from a partnership, the corporation receiving the interest does not own, and is not considered as owning (within the meaning of section 871(h)), 10 percent or more of the capital or the profits interest in such partnership. For purposes of this subsection the term 'registered form' has the same meaning as when used in section 163(f).".

(b) CONFORMING AMENDMENT.—Section 881(a) of such Code (relating to imposition of tax) is amended by striking out "There" and inserting in lieu thereof "Except as provided in subsection (c), there".

SEC. 3. AMENDMENT OF SECTION 864(c)(2).

Paragraph (2) of section 864(c) of the Internal Revenue Code of 1954 (relating to effectively connected income, etc.) is amended by striking out "section 871(a)(1) or section 881(a)" and inserting in lieu thereof "section 871(a)(1), section 871(a)(4), section 881(a) or section 881(c)".

SEC. 4. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

(a) Subpart C of part II of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new section:

"SEC. 898. REMOVAL OF EXEMPTION FROM TAX IN CASE OF INADEQUATE EXCHANGE OF INFORMATION.

"Whenever the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the exemption from tax contained in section 871(a)(4) and section 881(c) shall not apply to any payment or payments addressed to or for the account of persons within such foreign country after the date specified in the Secretary's determination. Any such removal shall not apply to interest on obligations issued on or before the date of publication of such determination. The removal of the exemption from tax contained in section 871(a)(4) and section 881(c) shall continue until the Secretary determines that the exchange of information between the United States and the foreign country of such information is adequate to prevent the evasion of the United States income tax by United States persons.".

(b) The table of sections for such subpart C is amended by adding at the end thereof the following new item:

"Sec. 898. Removal of exemption from tax in case of inadequate exchange of information."

SEC. 5. AMENDMENT OF SECTION 2105.

Subsection (b) of section 2105 of the Internal Revenue Code of 1954 (relating to property without the United States) is amended to read as follows:

"(b) Bank Deposits and Certain Other Debt Obligations.—For purposes of this subchapter—

"(1) amounts described in section 861(c), if any interest thereon would be treated by reason of section 861(a)(1)(A) as income from sources without the United States were such interest received by the decedent at the time of his death,

"(2) deposits with a foreign branch of a domestic corporation or domestic partnership, if such branch is engaged in the commercial banking business, and

"(3) debt obligations, if, without regard to whether a statement meeting the requirements of section 871(g) has been received, any interest thereon would be eligible for the exemption from tax under section 871(a)(4) were such interest received by the decedent at the time of his death,

shall not be deemed property within the United States.".

SEC. 6. WITHHOLDING.

(a) Nonresident Aliens.—Subsection (c) of section 1441 of the Internal Revenue Code of 1954 (relating to withholding of tax on nonresident aliens) is amended by adding at the end thereof the following new paragraph:

"(9) INCOME EXEMPT FROM TAX.—No deduction or withholding shall be required in the case of interest (including original issue discount) described in subparagraph (A), (B), or (C) of section 871(a)(4) unless the person otherwise required to deduct and withhold shall know, or have reason to know, that such item of income is not exempt from tax because of clause (i) or (ii) of section 871(a)(4).".

(b) FOREIGN CORPORATIONS.—The last sentence of section 1442(a) of such Code is amended—

(1) by striking out "and" after "section 881(a)(4),"; and

(2) by inserting ", and the reference in section 1441(c)(9) to clauses (i) and (ii) of section 871(a)(4) shall be treated as referring to clauses (ii), (iii), and (iv) of section 881(c)" after "section 881(a)(3)".

SEC. 7. EFFECTIVE DATES.

(a) The amendments made by this Act (other than section 5) shall apply to amounts paid after the date of enactment of this Act.

(b) The amendment made by section 5 shall apply to the estates of decedents dying after the date of enactment of this Act.

II

98TH CONGRESS
1ST SESSION

S. 1666

To amend the Internal Revenue Code of 1954 to reduce the capital gain tax rates for individuals who hold new issues of stock at least 5 years.

IN THE SENATE OF THE UNITED STATES

JULY 21 (legislative day, JULY 18), 1983

Mr. CHAFEE (for himself, Mr. BENTSEN, Mr. DURENBERGER, Mr. BOREN, Mr. WALLOP, Mr. PRYOR, Mr. COHEN, Mr. NUNN, Mr. D'AMATO, and Mr. DENTON) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to reduce the capital gain tax rates for individuals who hold new issues of stock at least 5 years.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Capital Formation Tax Act of 1983".

SEC. 2. 80 PERCENT CAPITAL GAINS DEDUCTION ATTRIBUTABLE TO NEW ISSUES OF STOCK HELD AT LEAST 5 YEARS.

(a) In General.—Section 1202 of the Internal Revenue Code of 1954 (relating to deduction for capital gains) is amended—

(1) by amending subsection (a) to read as follows:

"(a) Deduction Allowed.—

"(1) In general.—If for any taxable year a taxpayer other than a corporation has a net capital gain, there shall be allowed as a deduction from gross income an amount equal to the sum of—

"(A) 80 percent of the lesser of—

"(i) the net capital gain, or

"(ii) the qualified net capital gain, plus

"(B) 60 percent of the excess (if any) of—

"(i) the net capital gain, over

"(ii) the amount of the qualified net capital gain taken into account under subparagraph (A).", and

(2) by inserting after subsection (c) the following new subsection:

"(d) Qualified Net Capital Gain.—

"(1) In general.—For purposes of subsection (a), the term 'qualified net capital gain' means the amount of net capital gain which would be computed for any taxable year if, in determining net long-term capital gain for such taxable year, only qualified issues of stock held by the taxpayer for at least 5 years at the time of the sale or exchange were taken into account.

"(2) QUALIFIED ISSUES OF STOCK.—For purposes of subsection (d), the term 'qualified issues of stock' means issues of stock which—

"(A) are publicly or privately offered through an initial stock offering by any corporation,

"(B) are purchased from the initial offeror, underwriter, broker, or agent, and

"(C) represent contributions to capital or paid-in surplus of such corporation.".

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply to sales or exchanges after December 31, 1983.

Senator CHAFEE. Ladies and gentlemen, we welcome everybody to this joint hearing of the Subcomittee on Savings, Pensions, and Investment Policy and the Subcommittee on Taxation and Debt Management.

We are going to focus on four bills this afternoon representing a range of concerns. The first bill we will examine is S. 1666, "The Capital Formation Tax Act of 1983." This proposal has been introduced in response to a hearing we conducted by this subcommittee on "The Promotion of High Growth Industries and U.S. Competitiveness."

At that hearing, many witnesses testified to the need for incentives to promote capital formation and encourage a stable long-term investment environment that would assist new so-called high-tech companies developing advanced technologies and providing many benefits to our economy.

We learned at those hearings that access to capital is not only critical to smaller new ventures but also enables more mature companies to be innovative and forge ahead in the development of new advanced technology.

S. 1666 would reduce the maximum effective capital gains rate to 10 percent on issues that are publicly or privately offered through initial stock offerings and that are held for 5 or more years. The provisions of S. 1666 attempt to encourage investment in those companies during the most critical years of a new company by requiring that the stock be initial-issue stock. And of course, an older company can have an initial issue, as well.

In addition, the bill rewards investors who stay with a company for 5 years, during perhaps difficult times, and thus, provides more certainty for a company pursuing risky but innovative research and development in new technologies.

The next bill, S. 1550, is designed to correct the problem that has arisen with regard to the double taxation of overseas construction projects undertaken by U.S. contractors.

This bill permits a U.S. firm to deduct as a cost of doing business the foreign taxes paid on construction contract services, such as engineering, design, procurement, and cost scheduling, performed in the United States but taxed by the foreign country.

The purpose of this legislation is to put U.S. firms on a par with non-U.S. firms that are not taxed by their home countries and thereby retain and expand overseas construction projects which produce technical service jobs in the United States. In other words, it's a jobs bill just like the first bill. It's all designed to produce more jobs in the United States.

The third bill, S. 1557, "The Capital Tariff Repeal Act of 1983," would exempt foreign persons and foreign corporations from U.S. income and withholding taxes on interest income from debt obligations guaranteed by a domestic corporation.

Currently the United States levies and withholds a 30-percent income tax on nonresident aliens and foreign corporations receiving interest payments from U.S. corporations. This tax impairs U.S. competition in the worldwide debt market such as the Eurobond market and operates as a tariff, hindering the influx of foreign capital to help finance U.S. businesses.

As I understand it, this bill has the support of the Treasury Department, and of course we are going to be hearing from Mr. Chapoton on all of these pieces of legislation.

The last bill, S. 1066, "The Supplemental Retirement Benefit Act of 1983," addresses the concerns of retirees facing uncertainty with the future buying power of their private sector pension. This bill creates a workable mechanism for private pension plans to grant annual cost-of-living increases.

Presently, as we all know, most private pension plans do not provide cost-of-living increases for retirees. I understand in today's Washington Post there is an article indicating that for the larger U.S. companies studied only 3 percent provided for cost-of-living increases in their pension plans, although some two-fifths do adjust the retirees' benefits after the fact on an ad hoc basis.

This bill supplements employee benefits on a nondiscriminatory basis by allowing employers and employees to jointly purchase an insured annuity contract at the time of the employee's retirement, in order to fund what we call the supplement retirement benefits. These supplemental retirement benefits would be limited to the greater of 3 percent of a retiree's initial pension payment or a percent of the pension equal to the 7-year average of the cost-of-living increase, generally determined by using the CPI.

We have a great number of witnesses today to discuss these bills. But, we've got a time problem. We have 17 witnesses, I think, or 18, and there are going to be some Interior Department votes on the floor today. So we would ask the witnesses to limit their remarks to 10 minutes. We have to be pretty severe on the time here. Mr. Chapoton will have a little more. Did I say 10 minutes? Make that 5. Or thereabouts.

But we'll have to give Mr. Chapoton longer, since he's discussing the four pieces of legislation.

Now, we're delighted to have Congressman Ed Zschau here, who has a remarkable background in this whole area. He will speak, as I understand, generally on 1666 and share with us his views on other legislative initiatives.

Then, I understand, Delegate Won Pat is here, from Guam. Am I correct?

Mr. Won Pat. Yes.

Senator CHAFEE. Why don't you step up, too? Why don't you come right up, Mr. Won Pat. You are going to be testifying on the 30 percent withholding, I suppose.

All right. Congressman Zschau, we welcome you. Why don't you go right ahead.

STATEMENT OF HON. ED ZSCHAU, U.S. REPRESENTATIVE, STATE OF CALIFORNIA

Mr. ZSCHAU. Thank you very much, Mr. Chairman.

I will try to be brief. Before I begin my comments on S. 1666, I would like to compliment you on the impact of the hearings that you held earlier this year in January. We have seen bills coming into the Congress, in both the House and the Senate, to implement some of the suggestions that were made in those hearings. I want to commend you for holding those hearings and for following up with specific proposals.

Senator CHAFEE. Well, thank you. I must say, those were good hearings. But the proof of the pudding always is going to be in the eating, and we've got to produce.

Mr. ZSCHAU. Well, I think we are starting to chew it right now.

Senator CHAFEE. Good. Well, we won't follow that analogy any further. Keep going. [Laughter.]

Mr. ZSCHAU. I would like to comment on S. 1666. I believe that it is based accurately on the recognition of two fundamentals: One, that we have to encourage long-term investments that are usually riskier—we may need extra incentives for that—and, two, that the cost of capital generally in the United States is too high; we have to find ways of bringing that cost of capital down, particularly for those companies that are generating the jobs and making us more competitive.

However, on the specifics of S. 1666—how it implements these fundamentals—I do have some concerns, and I want to share them with you briefly.

No. 1, I question whether in the case of a public company it is possible to implement S. 1666; that is, to give special treatment to stock sold from the company vis-a-vis stock that is already in circulation.

For example, in an initial public offering, while the stock sold by the company is part of the offering, the stock that is sold by selling shareholders is also often part of the offering. All the stock is offered at the same price within one offering. It seems to me to be very difficult, if not impossible, to differentiate the company-sold stock—the "new" stock—from the secondary offering of the selling shareholders. Furthermore, even if we could do that, it makes an arbitrary distinction between stock that is being sold by the company and secondary sales that I believe is inappropriate.

Let me give you an example to illustrate that. Let's suppose there is a shareholder who already holds stock in a particular company. At the time of a new offering by that company, that shareholder may be interested in buying some of the new stock in order to get the favorable tax treatment offered by S. 1666. However, in order to get money to buy it, that shareholder may sell the stock he currently holds to a new investor. The new money coming into the deal actually comes from the new investor. The selling shareholder takes that money and buys new stock from the company. I don't feel that the person who sold the old stock and bought the new stock should get any special capital gains treatment. He didn't really add to the supply of investment capital. And yet that's the general way in which S. 1666 could work. I believe, as I say, it makes an arbitrary distinction between the sale of new stock and the sale of existing stock that may not be apprørpiate in order to encourage investment.

Senator CHAFEE. Let's go slowly on that. I didn't get that.

Mr. ZSCHAU. Well, at a time of a new offering——

Senator CHAFEE. What we are trying to do is encourage the investment in the company through purchase of an initial offering. Now, that doesn't mean the very original initial offering. These companies go through offerings several times, don't they?

Mr. **Zschau**. That's correct.

Senator **Chafee**. They have to keep going back to the well.

OK. Now, what's your problem with that?

Mr. **Zschau**. On a given day when there is a new offering made, there may also be sales of the existing stock, sold at the same price with the same element of risk. I feel that it is inappropriate to make a distinction between the stock that is sold by the company and the stock that is sold at the same time at the same price with the same degree of risk to other investors.

The example I gave is one in which the new money coming into the deal could come from a new investor buying from a selling shareholder—that's the new money coming to the company—with the selling shareholder taking that money and buying the new stock. The selling shareholder has not contributed any more to the pool of investment capital but would get special tax treatment merely because he bought the shares from the company as opposed to buying shares that were already on the market. It's for that reason that I don't feel that we should make special treatment on a capital gains basis between original stock being sold and secondary stock being sold. It's all part of the overall capital pool.

Let me just quickly make a third comment. I believe that when you encourage retention of a given stock—that is, you offer a lower capital gains tax if a share holder has held stock for 5 years in the case of S. 1666—you may decrease the mobility of capital, the liquidity, and the likelihood that shares are going to be traded.

The relationship between liquidity and the cost of capital is that the higher the liquidity, the more mobility in the shares, the lower the cost of capital will be. By introducing an arbitrary incentive to hold the shares longer than a shareholder might otherwise have done, it may be counterproductive to what you are trying to achieve. You are trying to achieve lower cost of capital but offering a lower tax for a longer holding may actually increase the cost of capital.

I wanted to take this opportunity to bring before you some concerns that I have. I realize that these are pretty subtle and perhaps complex, and I would be delighted to get together with your staff after the hearings and go through some specific examples and details of my thoughts. I appreciate the opportunity to suggest them before you in this hearing.

Senator **Chafee**. Well, in other words, you don't like the 5-year holding period.

Mr. **Zschau**. I don't like the 5-year holding period. I believe that if you are trying to adjust for risk that is attendant to holding stock that is less liquid, an alternative approach would be to index capital gains for inflation; that is, the longer you hold it, the less the nominal gain would be. But I don't see why we should set an arbitrary cut off. For example, under S. 1666, if you hold it for 5 years, you get a lower tax rate; if you hold it for 4 years you pay a higher tax rate. I think that that would restrict the mobility of capital and result, in many instances, in increasing the cost of capital rather than reducing it for U.S. firms.

Senator **Chafee**. Well, as you know, the venture capital people who are here that testified in the spring when we had the hearings, they saw no problem with the holding period of 5 years. They thought if you were going into one of these things, you were going to stick it out. So that didn't present them any concerns.

Now, indeed, they were venture capital firms; they weren't individuals.

Mr. ZSCHAU. Well, I think you have witnesses from the venture capital community today, and they could followup and perhaps comment on my particular concern. I would like to point out that in a typical venture capital deal, the holding period may be 5 years or longer. In those cases, under S. 1666, they could get 10 percent capital gains tax rather than 20 percent capital gains tax for doing what they are doing anyway, it would be attractive to them.

I guess I am looking at it more from the cost of capital of the company—what would reduce the cost of capital for a U.S. company. I am concerned that a tax policy that restricts the mobility of capital, restricts liquidity, provides incentives for people to hold on to investments longer than they might otherwise economically do, will increase the cost of capital generally rather than reduce it.

Senator CHAFEE. Well, thank you very much for those thoughtful views, Representative Zschau, and obviously you are a leader in this area, and we will be talking to you as we go ahead.

Mr. ZSCHAU. I appreciate that opportunity.

Senator CHAFEE. I know you have a busy schedule, so feel perfectly free to leave if you so choose. Don't feel you have to stay.

Mr. ZSCHAU. I thank you very much.

Senator CHAFEE. Thank you very much for coming over.

Mr. Pat, we welcome you here and look forward to hearing your thoughts. Why don't you proceed.

STATEMENT OF HON. ANTONIO BORJA WON PAT, U.S. REPRESENTATIVE, GUAM

Mr. WON PAT. Good afternoon, Mr. Chairman.

I want to thank you for the opportunity to comment on S. 1557 in my capacities as chairman of the House Subcommittee on Insular Affairs and Delegate of the Territory of Guam. I appear in both capacities because, although the potential effects of the legislation are of greatest concern to my own territory, they are of interest to other territories as well.

In 1972, I lobbied Congress to exempt Guam from the 30-percent withholding tax on investment income which was applied to the Territory under the so-called mirror system of taxation. The intent of section 881(b) of the Internal Revenue Code was to stimulate investment and help accomplish the Federal goal of developing the economy of the island.

For a variety of reasons, there was little interest in the potential of this exemption until last year. Then, when substantial interest developed because of the Reagan administration's effort to crack down on conduit financing through foreign tax havens and other factors, the IRS issued an illegitimate regulation to preclude the use of section 881(b). It does so by providing that territorial source investment income is treated as U.S. source income when not subject to territorial taxation. Thus, it effectively reimposes the 30-percent barrier from which Guam and other territories are supposedly exempted by law.

The regulation was designed to prevent foreign investors from using territorial corporations to avoid the U.S. tax on U.S. investments. It also, however, discourages investment from or through the United States in our island.

Guam's capable Governor, Ricardo Bordallo, is aggressively leading the fight against this excessive regulatory grab of authority. From the beginning he pressed for a reasonable compromise designed to insure that the abuses of tax-treaty nations was not repeated on Guam. And he has reported obtaining support for our position from the lead agency for territories, the Department of the Interior, and the National Governors Association, among others.

At first we were told by Treasury that it would resolve the dispute with no less favorable treatment when the sensitive negotiations with the Netherlands Antilles were finalized and those foreign islands were "shut down" as a conduit tax haven.

Then, when the Antilles was extended, we were told Treasury wanted to see whether Congress would remove the 30-percent withholding tax altogether.

I am not going to question the wisdom of the bill before you today. If you believe that it is good tax and economic policy for the Nation, it should be supported. The advantages of Guam's current exemption will of course be obviated. But I do object to holding Guam and other territories hostage to the fate of this bill and the Netherlands Antilles situation. It is unjust for the IRS to administratively deny us a favorable tax situation accorded by Congress and the President. It is unfair to treat American islands less favorably than foreign tax haven islands, as is the case now. It is wrong to prevent us from accomplishing the Federal purpose of developing our economy through this exemption when the Federal law imposing the 30-percent withholding tax with respect to other parts of the Nation still stands.

In conclusion, I ask that your subcommittee direct Treasury to uphold the letter and intent of current law. I would like to have my staff and those assisting Governor Bordallo work with your staff in this respect.

Thank you.

Senator Chafee. Well, thank you very much, Delegate Won Pat. We appreciate your thoughtfulness.

As I get the situation, Guam would like to be in the same situation as the Netherlands Antilles but has not been accorded that treatment. And as you say in the last page of your written statement, Treasury is holding up granting that authority because this legislation is pending, and this legislation may eliminate it all. Is that correct?

Mr. Won Pat. Yes, sir. It is unfair, of course. The Antilles is a foreign country, and by treaty they are afforded that; whereas Guam, under the law, could legally, in a sense, operate that.

Senator Chafee. I see.

Well, thank you. Mr. Chapoton, representing the Treasury Department, will be testifying here, and so we will speak to him about that.

Of course, the best thing of all is to get this legislation passed, then it would solve all the problems, I suppose.

Mr. Won Pat. I suppose so.

Senator Chafee. It will settle it, anyway.

Mr. Won Pat. Well, I am looking forward to talking with Mr. Chapoton and other Treasury officia[illegible], following up the Governors Conference again.

Thank you again, Mr. Chairman.

Senator Chafee. Thank you for coming. I appreciate your taking the trouble.

All right. Now, Mr. Chapoton, and whoever you wish to be with you, we welcome you here.

I assume you will address all four pieces of legislation.

Mr. Chapoton. Yes, sir, I will. And I have them arranged in a little different order. I assume you don't care which order they are in.

Senator Chafee. That's perfectly all right. Take them in any order you want. Just, if you would, clearly designate which one you are discussing at each time.

Mr. Chapoton. Right.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. Chapoton. I will try to run through these fairly quickly, because I think we may have some questions.

First I will deal with S. 1066, which would be labeled "The Supplement Retirement Benefit Act of 1983." This bill would enable an employer to make a special supplemental contribution in the year of a participant's retirement from employment to fund a supplemental retirement benefit, which is referred to as an "SRB," under a qualified defined contribution plan for that participant.

The participant would have to elect to receive his benefit from a defined benefit plan as an annuity. The SRB would be in the form of an insured annuity providing benefits to offset cost-of-living increases that would otherwise erode the benefit of the participant's annuity from the defined benefit plan.

We do not support the approach posed in S. 1066, Mr. Chairman. We have serious doubts that it is appropriate to authorize an employer-provided qualified plan benefit that is in the nature of a benefit typically provided by a defined benefit plan without that benefit being subjected to both the benefit accrual and minimum funding rules enacted by ERISA. These rules, in conjunction with the vesting rules, are among the most essential in providing employees with a high level of retirement income security, and thus we think the approach of 1066 should be embraced only if that goal cannot be attained in a less drastic fashion.

We recognize the problem that is sought to be addressed by this bill, that cost-of-living increases may seriously erode the value of a retiree's annuity, and we are aware that employers hesitate to provide employees with cost-of-living protection as a part of a basic retirement benefit because of the uncertainty of the financial obligation associated with providing that benefit.

We suggest that consideration be given to alternative methods of encouraging employers to provide the cost of living in qualified plans, and therefore we must oppose 1066.

Senator **Chafee**. Let's take these individually, Mr. Chapoton, as we go along here.

I understand your opposition to 1066. However, in the final sentence of your testimony you indicate that there are alternate methods of encouraging employers to provide cost-of-living protection in qualified plans. Do you think there is a possibility of our working something out?

Mr. **Chapoton**. I think we can work together. I think there will not be any alternative methods as direct as this plan. Basically I think we can cut through it very quickly—this method would run counter to the policy of having the accrual and vesting rules. And like any other benefit that could be provided at the end of the line, if you will, then the security that we seek in ERISA simply would not be there; the employer could do it, or the employer could not do it, by changing the plan.

But I don't want to imply that we have dramatic alternatives to offer. One is that the employers can do it on an ad hoc basis, as they sometimes do. Others, they simply could provide the benefit in the plan itself. But we recognize that's expensive, and alternatively they could permit a defined contribution plan to offer the benefit at the end of the line.

Or we could talk about working with perhaps the deduction rules to give greater encouragement to employers to provide cost-of-living annuities at the termination. But we simply think that we must not just wholly avoid the protection that ERISA is designed to provide.

So, I am saying I don't think we can get nearly as far as this bill would go in any of the approaches we are suggesting.

Senator **Chafee**. All right. By "all right," I mean "Yes, I heard you." [Laughter.]

Why don't you take the next one?

Mr. **Chapoton**. OK.

The next one would be the deduction for foreign taxes on U.S. construction company services income. This bill would allow certain companies to deduct foreign taxes imposed on the income they derive from services performed in the United States in connection with a foreign construction project while continuing to allow foreign tax credit on other income.

Basically, as you know, Mr. Chairman, the United States permits taxpayers to credit against their U.S. tax liability income taxes paid to foreign governments with respect to foreign source income. The credit is limited to foreign source income through the 904 limitation formula, which is a worldwide limit, which basically says any qualifiying taxes paid to a foreign government are OK, but the total amount of the credit could not exceed a percentage determined by your worldwide income as the denominator and your foreign source income as the numerator.

The problem these companies run into is that they have a foreign country levying a tax on what is U.S. source income. For example, the foreign country in some of these cases imposes a tax on amounts paid by a resident of the foreign country to a U.S. construction company for engineering services performed in the United States but which relate to the construction of a manufacturing facility in that foreign country. Under our law they would qualify as income taxes, and therefore we would allow the foreign tax credit. But when you move over into the limitation, the limitation would catch such a company unless it has low tax foreign source income in other countries; but as long as it is in an excess credit position or has no other foreign source income, it is not going to be able to use the credit that is generated, because its foreign taxes will exceed the section 904 limitation.

This is a practical problem. We sympathize with the burden such foreign taxes represent, but we candidly think the problem is caused by the foreign country and not by our law.

The U.S. rule is that income from services has its source where the services are performed, and that rule is shared by virtually all developed countries and many developing countries. It is in the Model Income Tax Treaty prepared for the United Nation, and it is the rule we use in negotiating income tax treaties. We don't think we can reject that principle for this situation.

A proper remedy is for these foreign countries to limit their tax on U.S. companies to income from service performed within their borders.

If we unilaterally undertook to mitigate the effect of the excessive foreign taxes by picking up 46 percent of the cost to the taxpayer, we would encourage the use of these taxes by other countries rather than putting the responsibility on the foreign countries to cure the problem of their own making.

It is a difficult problem, but it raises the very serious question of our source of income rules. It's a much broader question than is presented by these limited cases, and we think it is not correct for us to be asked to suffer the burden of a tax imposed by these foreign countries.

Turning to S. 1557, Mr. Chairman, that is the bill that would eliminate the withholding tax, the U.S. withholding tax, on interest paid holders of debt obligations where the holder is a nonresident of the United States and a noncitizen of the United States.

There are three specific categories of interest that would be exempt, but basically it's a debt instrument sold under arrangements designed to insure that the debt instrument would not be sold to U.S. persons. Interest will not be exempt even if those conditions are met, if the recipient owns a 10-percent interest in the voting power of the payor—that is to say, it will have to be a portfolio debt instrument and not a debt instrument held by a person who is also a major equity owner of the obligor corporation.

The bill also provides that the Secretary of the Treasury may remove the exemption if he determines that the country which primarily benefits with respect to any new obligations does not exchange information with the United States to prevent evasion of U.S. taxes by U.S. persons.

We strongly support this exemption, Mr. Chairman. We believe that access to foreign capital markets is an important element in achieving increased capital formation and sustained growth in this country. And we think this would be a major step in that direction.

As we all know, tax-free access is now generally possible through the careful use of some statutory provisions, and, more importantly, some treaty exemptions. But to gain such access, American companies frequently must employ costly and complex mechanisms.

This would eliminate that need. American companies would be able to borrow directly in the foreign capital markets and would not have to use the back door routes that they now have to use.

As the result of ending those arrangements, the bill would have a slight revenue pickup, because it would have the effect of eliminating foreign taxes paid to one particular intermediate country, the Netherlands Antilles, which taxes are a credit against U.S. tax liabilities. So you get rid of that. And there is so little of this income that is now subjected to U.S. tax, the net result would be a slight revenue pickup.

And we think, more importantly, not the revenue considerations but the basic policy of free access to the foreign markets is certainly desirable.

Senator **Chafee**. Do you think, first, it would result in any increased jobs in the United States in our handling this paper work, modest though it might be? Second, do you think the increased access would be beneficial to the United States? And third, Would there be an increased access of foreign capital to U.S. markets?

Mr. **Chapoton**. I think there would clearly be an increased access. I think it would be yet another easier source of capital for U.S. companies. And so the long-term effect would be very positive.

I think the increased jobs part would be very problematical. I think it would be difficult to put a hard number on that.

Senator **Chafee**. What about the problems Delegate Won Pat raised?

Mr. **Chapoton**. Mr. Chairman, his concerns are basically that Guam has reviewed current rules with respect to taxation of possessions and concluded that Guam could do basically what the Netherlands Antilles now does. But of course we have no treaty with Guam. The Antilles does it through a treaty—United States-Netherlands Antilles Treaty. We have reviewed these same provisions, the so-called "mirror code" which is extremely complex, and while we see the reading of the letter of the law that Mr. Won Pat describes, we reach a very definite conclusion at odds with their conclusion, and we have so stated in proposed regulations. We have now heard comments on those regulations. I believe I am correct in saying we have not tied the regulations to our discussions with the Antilles, though obviously that is in our minds, frankly speaking. We do have this problem in the Antilles and we do not believe that another route toward what is, in effect, avoiding the U.S. 30-percent withholding tax should be facilitated under a provision that was certainly not designed for that purpose. If this possibility does exist under the mirror code, we have a serious question about the policy of that result.

Senator **Chafee**. Is this routing through the Netherlands Antilles a rather massive undertaking in volume?

Mr. **Chapoton**. It is massive in terms of the dollar volume, yes, sir—the dollar volume of issues that goes through the Antilles.

The paperwork is significant. I think one of the things that concerns us most now is the uncertainty of using the Antilles as a route. There are cases under audit that have been publicized by corporations that are under audit, where the question has been raised whether the back-to-back financing through the Netherlands

Antilles in fact complies with the treaty. That has caused some uncertainty among other companies that would use the same route.

Senator CHAFEE. All right, thank you. Why don't you go to the last one.

Mr. CHAPOTON. OK.

The final bill is S. 1666, which would basically reduce the capital gains tax in half from a maximum of 20 percent to a maximum of 10 percent, with respect to new issues when held by an individual investor, original issues of stock. And there would be, as you have already discussed with Congressman Zchau, a 5-year holding period.

The purpose of S. 1666 is, as you have indicated, to increase the rate of capital formation in this country. While we are very sympathetic with that goal, we must oppose S. 1666 because we do not think it would efficiently achieve that goal and indeed might impede capital formation.

We think the goal you suggest would be better achieved by a comprehensive elimination of the features of current law which tend to impede capital formation.

Moreover, we object to the targeting approach used by this bill. We think that it would be relatively inefficient and would lead to changes in economic behavior that would give us some concern.

The bill would, of course, distinguish between newly issued corporate shares and all other forms of saving, granting special tax benefits only to the newly issued shares. Obviously persons would change their economic behavior in response to this. For example, it would decrease the relative rate of tax on businesses that use new capital, and the bill would thus direct economic activity away from the relatively higher taxed service industries and other industries that do not require new capital.

Also, by providing an incentive only for new issues of corporate stock, the bill would change investment patterns. Funds would be attracted away from other investments to new shares which offer increased after-tax returns. And when we have a basically fixed total capital supply in the short term, a greater allocation of capital to new corporate stock would mean a reduced availability and higher cost of capital for businesses that do not issue new stock—for example, debt capital. So we could expect that businesses would be required to pay somewhat higher rates of interest on borrowings.

And third, the bill would encourage the incorporation of a business to secure the tax benefits, where a corporation would not otherwise have been the mode in which the business was carried on.

We also feel there is not an economic justification for linking reduced tax rates to a 5-year holding period. Under current law there is a benefit for holding assets for a longer period of time. That is, basically, if you assume some appreciation ratably over a period of years, the taxpayer, the holder, is benefited the longer he holds the asset because he defers the tax on the appreciation which occurs each year. That is true even if you take into account the fact that a part of his nominal gain is eroded each year by inflation.

The effective tax rate on gains accrued evenly over a 5-year period and taxed at the end of the period is going to be less than the tax if the gains accrued during 1 year and were taxed during that year. So we generally have a bias for longer holding in the law now, and we do not think that a decreased rate of tax generally should be linked to a longer holding period.

And as Congressman Zschau pointed out, we would concur that the 5-year holding period would in effect lock in investors for this period of time, and thus would lead to some inefficient economic decisions.

We also indicate in this statement, Mr. Chairman, some unintended and undesirable, but I recognize they are unintended, effects of the bill. For example, it would apply to any new stock issue. We estimate that 80 percent of new corporate stock issues are sold by established corporations, and thus they would be the principal beneficiaries of the bill, not the young growth companies that we think the bill is designed to benefit.

It would also apply to new issues of shares even though they don't represent new capital. For example, in addition to the case that the Congressman pointed out, the corporation itself could issue new stock to finance acquisitions of old shares, which basically would be a churning operation. The new shares would have a tax advantage, and thus would sell for a higher price; and the old shares could be repurchased at a lower price, even though the same stock in the same company. Gain would flow to the company—a nontaxed unrecognized gain would flow to the company—but there would be no additional capital formation overall.

We point out it might be possible to alleviate some of these problems with appropriate antiabuse provisions, but we think any effort to define and trade shares attributable to new capital would present very significant difficulties.

Senator CHAFEE. Well, what are you aiming at here? At the top of page 15 of your statement, you say you believe "the goal of an increased rate of capital formation could be achieved more efficiently by a comprehensive elimination of those features of our current tax system which impede capital formation"—such as——

Mr. CHAPOTON. Well, I think we took major steps in this direction in 1981. But one of the major problems we have, of course, is the two-phased tax: The corporate tax and the second tax on dividends. If we want to encourage capital formation, we should look at the possibility of lowering the double tax on corporate earnings, certainly one of the best approaches.

In addition, when we see individual targeted-type relief provisions, I think we can anticipate that there will be some inefficiency involved. We should instead strive for broad-based changes that don't lead to the economic distortions that targeted relief causes.

I must concede that, at the present time because of the deficit, there is relatively little we can do in a major way toward capital formation, but I think that's where our efforts should be expanded.

Senator CHAFEE. Well, as a matter of fact, we moved away from reducing the double taxation on dividends by decreasing the amount that was deductible for interest and dividends a couple of years ago. Didn't we?

Mr. CHAPOTON. That's right. But in terms of incentives, Mr. Chairman, that probably wasn't as significant, because it was across-the-board and benefitted a lot of people who would already be above that amount. So it was not an incentive to create new capital formation by most taxpayers.

Senator CHAFEE. Yes, but it was a little step toward it.

Mr. CHAPOTON. That is correct.

Senator CHAFEE. Our problem is this, Mr. Chapoton. We all say—I wish there was a better word than "high tech," but industries that are involved in advancing frontiers of technology represent a great growth potential for our Nation in jobs, plus exports. And we are in a very severe competitive situation with foreign countries, notably Japan. So let's do everything we can to help these companies. Sure, it might require some distortion of the tax laws, but—so what?

And yet when we come up with proposed legislation it isn't going to cure everything, but there is no proposal we are going to come up with that is going to be a panacea. It's a whole series of perhaps small steps that we might take. And here is one here that seems to have considerable merit. Yet you have done everything you can to shoot it down.

Mr. CHAPOTON. Well, Mr. Chairman, I speak to a lot of these groups also. I think basically that we have the capital gain rate considerably lower than it's been. We have seen a major inflow of capital into the venture capital area.

I honestly think that one thing we could do is to leave it alone for a while. I think the tax climate is quite favorable to obtaining capital by these firms, and I think they are finding that to be the case.

I think we should look at the R&D credit, which this committee and we at Treasury are doing, to see if it is working correctly, and to extend the credit. We have, as you know, supported a 3-year extension of the credit, and we want to work on the definitions that are involved there.

Senator CHAFEE. Those definitions would be by regulation, wouldn't they?

Mr. CHAPOTON. Well, I think we might come to the conclusion that we want to support some legislative changes in the definition, as well.

Senator CHAFEE. Well, I think you're right in that. I mean, when we had the testimony in the spring on this matter from the companies involved, they didn't say this was the greatest thing that ever came along, and they indicated, as you have suggested, that the most dramatic event had been the reduction of the capital gains to 20 percent. They would like more, sure. This would be helpful.

Well, we will listen to see what they say in the further testimony.

Mr. CHAPOTON. All right.

Senator CHAFEE. But the other points you made on the extension and indeed the broadening of the R&D tax credit are major ones. I hope this committee and Treasury can get on with such measures.

Mr. CHAPOTON. Yes, we want to.

Senator CHAFEE. Let's go back. Again, we are getting into competition, international competition, and the export situation in connection with the contracts abroad doing the design, architectural work, engineering, and so forth.

Now, your answer, as I understood it here, was that this raises a host of problems. If we did this as suggested by our legislation it would encourage foreign countries to broaden the areas they are currently taxing, figuring we would then take the step and make it deductible or a tax credit against those foreign taxes.

And you seem to indicate that the solution really was in treaties with those countries, to get them to stop taxing the areas that they shouldn't be taxing. What is the hope of achieving that?

Mr. CHAPOTON. Well, that would be the ideal. That would be the No. 1 solution. And we have had a great deal of success in enlarging our treaty program, and over the years that effort will probably mitigate these types of problems almost to the point that they don't exist. But in the meantime they are going to exist—we have to recognize that.

I think our answer is—and it is somewhat harsh because there is a real problem here; I recognize that—but the answer has to be that the pressure should be put on the other country. I don't see how the United States can say when you tax income that is earned here under normal, well-recognized standards, you tax U.S. source income, then we in turn will say that our limits on the benefits for foreign taxes paid do not apply and therefore give you relief from that tax. We did not cause the problem and they did, and the pressure should be on the country that caused the problem.

Senator CHAFEE. You were very helpful when we dealt with these companies, in connection with changes in 911, which hopefully increased the competitive position of our contract firms, and obviously this is directed toward that same group of companies, to help them in their overseas contracts.

Well, let's see. Who is going to carry the ball on that attempting to achieve? Is it a hopeless task?

Mr. CHAPOTON. Mr. Chairman, we have not got yet what I consider adequate information on the specifics of these problems. And I would encourage you when you speak to the people here to make sure that we get more information on the specific problems raised by these bills. In other words, we are having trouble quantifying the magnitude of this change on a particular contract. But that's a detail. We would still like that detailed information, but I think no matter what we see, and we are going to see some cases—I am sure there are some cases where it is quite severe—it will be very difficult for the relief to come from the U.S. Government. The relief can come through treaties, and I think we ought to concentrate our efforts in that direction.

Senator CHAFEE. How often do we have a treaty of this nature, say with Saudi Arabia?

Mr. CHAPOTON. We do not have a treaty with Saudi Arabia. There has been some discussion of the possibility of starting negotiations with them.

But we have treaties with a great number of countries.

Senator CHAFEE. I mean, do we have a treaty with Nigeria, for example? Indonesia? In this area?

Mr. CHAPOTON. We have approximately 35 treaties. We have had discussions with Saudi Arabia, and we have had discussions with Nigeria. We do not have treaties with either of those countries, though.

Senator **Chafee**. All right, fine. We will be talking with you more, Mr. Chapoton, as we go along with this legislation. I appreciate your coming up today.

Mr. **Chapoton**. Thank you, Mr. Chairman.

[Mr. Chapoton's prepared statement follows:]

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STATEMENT OF
THE HONORABLE
JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEES ON SAVINGS, PENSIONS AND INVESTMENT POLICY AND TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE

Mr. Chairmen and Members of the Subcommittees:

I am pleased to present the views of the Treasury Department on the following bills:

S. 1066, which would enable an employer with a qualified defined benefit pension plan to fund retirement benefits in the form of a cost-of-living annuity by a one time contribution for a supplemental retirement benefit under a qualified defined contribution plan in the year of retirement;

S. 1550, which would allow U.S. taxpayers to deduct foreign taxes on services performed in the U.S. in connection with a foreign construction project instead of claiming a tax credit for such taxes;

S. 1557, which would provide for a more efficient mechanism for U.S. corporations to borrow funds abroad; and

S. 1666, which would reduce the rate of capital gain tax paid by an individual on gain attributable to certain newly issued corporate stock which is held by the original investor for 5 years or longer.

I will discuss each of these bills in turn.

S. 1066
Supplemental Retirement Benefit Act of 1983

S. 1066 would enable an employer to make a special supplemental contribution in the year of a participant's retirement solely to fund a supplemental retirement benefit (SRB) under a qualified defined contribution plan for such participant if the participant has elected to receive his retirement benefits from a defined benefit plan as an annuity. The SRB would be in the form of an insured annuity providing benefits to offset increases in the cost-of-living that otherwise would erode the value of the participant's annuity benefits from the defined benefit plan.

We do not support the approach proposed in S. 1066 to enable employers to protect the retirement annuity benefits of retired employees from the effects of cost-of-living increases after retirement. We have very serious doubts that it is appropriate to authorize an employer-provided, qualified plan benefit that is in the nature of a benefit typically provided by a defined benefit plan, without the benefit being subject to both the benefit accrual and minimum funding rules enacted by ERISA. These rules, in conjunction with the vesting rules, are among the most essential in providing employees with a high level of retirement income security. As a result, the approach proposed by S. 1066 should be embraced only if the desired goal cannot be attained in a less drastic fashion.

Nevertheless, we recognize that cost-of-living increases may seriously erode the value of a retiree's annuity benefits during his years of retirement. In addition, we are aware that employers hesitate to provide employees with cost-of-living protection as part of the basic retirement benefit in a defined benefit plan because of the uncertainty of the financial obligation associated with being required to accrue and fund such protection over an employee's years of participation in the plan. Accordingly, we suggest that consideration be given to alternative methods of encouraging employers to provide cost-of-living protection in qualified plans.

Background

A typical SRB arrangement, satisfying the rules proposed in S. 1066, would operate in the following fashion. In the year in which a participant in both a defined contribution plan and a defined benefit plan retires, the participant would be given an option under the defined contribution plan to receive an SRB. S.

1066 provides that this option must be made available to each such participant by the earlier of the year in which (i) the participant attains the normal retirement age under the defined benefit plan and retires, or (ii) the payment of the participant's retirement benefit from the defined benefit plan begins. The SRB option would be available to the participant under the defined contribution plan along with the plan's other benefit options (e.g., lump sum, installments, annuity).

If a participant elects to receive an SRB, the defined contribution plan would purchase an annuity contract on behalf of the participant from a state-licensed insurance carrier before retirement annuity benefits commence under the defined benefit plan. Under S. 1066, the defined contribution plan would be permitted to provide that the cost of the contract would be shared, in a stated proportion, by both the employee and the employer. The employee's share of the cost could come out of employee-derived or employer-derived funds in the his defined contribution plan account. The employer's share would be funded by a special supplemental contribution to the defined contribution plan on behalf of the participant.

S. 1066 would permit an employer to make and deduct the supplemental contributions to the defined contribution plan to purchase the SRB annuity contract without regard to the limitations on either annual additions on behalf of participants under section 415 of the Code or deductible employer contributions under section 404 of the Code.

The SRB contract would be distributed by the defined contribution plan to the participant before any amounts had been paid under the contract. The employee would not be taxed on the contract upon distribution (although its distribution may alter the amount of tax an employee would owe under the 10-year averaging rules), but instead would be taxed on amounts only as they were actually paid to him.

The SRB payments for a year would be a percentage, determined under the terms of the SRB annuity contract, of the annuity benefit payable under the defined benefit plan for that year. S. 1066 does not require that the percentage increase be calculated in any particular way. It does, however, impose a cap, which would be determined at the time the annuity benefits commence under the defined benefit plan, on the SRB payment attributable to a supplemental contribution that may be made in any year.

S. 1066 would impose a special rule for purposes of determining whether the anti-discrimination rule of section 401(a)(4) of the Code has been satisfied with respect to the supplemental employer contributions to the defined contribution plan. The special rule provides that the SRB arrangement in the defined contribution plan satisfies section 401(a)(4) if the employees eligible to benefit under the arrangement constitute either 70 percent or a fair cross-section of the employer's employees.

Discussion

The principal issues raised by an evaluation of S. 1066 are whether the need to encourage more employers to provide employees with additional cost-of-living protection during their retirement years justifies an exception to the benefit accrual and minimum funding rules applicable to qualified defined benefit plans and, if so, whether the approach of S. 1066 is the best method for accomplishing this goal.

Even assuming that retirees currently are not adequately protected against increases in the cost-of-living, we are not convinced that it is necessary to provide an exception to the benefit accrual and minimum funding rules applicable to qualified plans in order to encourage employers to provide such protection. The accrual and funding rules are too fundamental to the essential function of qualified plans, which is to provide employees with security that their promised retirement benefits will be paid when due, to adopt the approach proposed by S. 1066. An employer should not be permitted to provide supplemental retirement benefits under a qualified plan on a less secure basis than the basic retirement benefits. We also are concerned that excepting SRBs from the accrual and funding rules would, in the long run, encourage employers to provide increasing portions of the total retirement benefits provided under qualified plans in the form of such supplemental benefits. This would result in a general weakening of the retirement income security that has resulted from the enactment of ERISA.

The benefit accrual rules primarily are aimed at preventing avoidance of the minimum vesting standards by the backloading of benefit accruals. Backloading essentially consists of providing relatively low rates of accrual in an employee's early years of service and concentrating the accrual of benefits in the employee's later years of service. Under S. 1066, an employee generally would accrue a right to the SRB only upon retirement; an employee who separates from service before retirement would not accrue a right to the SRB. In addition, because the employer would be free to decide, at any time, to cease offering an SRB option under the defined contribution plan, an active employee would have no guarantee that the SRB option will be available to him if he eventually does retire from the employer.

Similarly, the minimum funding rules are based upon the recognition that the rights granted to participants under the minimum vesting and accrual rules are of real benefit only if a plan is able to pay the promised benefits when due. Accordingly, the funding rules provide for the orderly payment of plan costs by employers over the participant's years of participation, thereby increasing the likelihood that the necessary funds will be available when benefits are to be paid. Indeed, ERISA explicitly provides that both terminal and current funding methods are unacceptable. Permitting the employer to fund an SRB in only one year is inconsistent with these important policies.

With respect to the application of the benefit accrual and minimum funding rules to the proposed SRBs, we recognize that an SRB would be provided under a contract purchased and distributed by a defined contribution plan and that defined contributions plans are not subject to the accrual or funding rules. Nevertheless, both the availability and amount of an SRB would be closely linked with an employee's retirement benefits under a defined benefit plan: the time at which an SRB becomes available would be determined by reference to the normal retirement age and to the date benefits begin under the defined benefit plan, SRBs would be available only to participants in defined benefit plans, and the amount of an SRB would be based on the amount of the benefit under a defined benefit plan. In addition, the supplemental employer contribution in an employee's year of retirement essentially is a fulfillment of the employer's unfunded commitment to provide the SRB. Moreover, the amount of the supplemental contribution is determined by reference to the cost of the SRB. Accordingly, an employer-provided SRB is more appropriately classified as a benefit provided under a defined benefit plan and thus should be evaluated in terms of the standards applicable to defined benefit plans.

In addition to the inappropriateness of providing an exception to the accrual and funding rules for SRBs, we note that current law provides employers with several approaches to providing retired employees with supplemental retirement benefits. Regardless of the relative advantages and disadvantages of these approaches as compared with S. 1066, it is important to recognize that they are available.

For example, an employer may make supplemental payments on an ad hoc basis out of general corporate assets. In addition, an employer may purchase an SRB-type annuity contract, either out of employer funds or jointly with the employee, at the time of the employee's retirement. Current law also would permit a defined contribution plan to offer its participants a supplemental benefit based on a participant's annuity benefit under a defined benefit plan, if the supplemental benefit is purchased entirely out of the employee's account balance in the defined contribution plan.

Also, there are two basic approaches under current law that would enable an employer to provide supplemental benefits under a defined benefit plan from which the associated retirement annuity benefits are being paid. First, an employer periodically may amend its defined benefit plan to increase the benefits payable to certain employees, such as retirees who retired on or before a particular date, or retroactively to increase benefit accruals for certain periods of time, including benefits accrued by retirees for periods of service before retirement. The other basic approach is to provide participants in the defined benefit plan with an automatic, indexed annuity benefit. A participant's right to the indexed portion of his retirement benefit would accrue in conjunction with the accrual of the participant's basic retirement benefit over the participant's years of participation. The employer also would be required to fund this benefit over these years in accordance with the minimum funding rules.

Finally, in concluding that an exception to the accrual and funding rules is not justified, we are not yet convinced that it is not possible to provide employers with greater incentives to provide supplemental benefits in qualified plans under the currently available approaches without creating such an exception. For example, there may be ways in which to alter the deductibility of employer contributions to fund supplemental benefits that will encourage employers to provide such benefits. We would like very much to work with the Committee and the proponents of S. 1066 and other interested parties in exploring alternative approaches.

Quite apart from our basic conclusion that it is not necessary to make an exception to the accrual and funding rules in order to encourage employers to provide supplemental retirement benefits, we have strong objections to specific aspects of S. 1066.

First, S. 1066 requires that an employer maintain both a defined contribution plan and a defined benefit plan. Employees of employers that maintain only one of these types of plans would not be benefited. Undoubtedly, an acceptable approach would have to enable an employer to provide a supplemental retirement benefit in either type of plan. Indeed, we believe that it would be appropriate to require that the supplemental retirement benefit be provided in the plan that provides the basic retirement benefit to which the supplemental benefit is linked.

Second, S. 1066 would benefit only employees who separate from service upon retirement; employees who separate from service with the employer before retirement age would not be eligible to receive a SRB annuity contract. This constitutes a direct violation of the accrual and backloading rules, which were enacted in ERISA to prevent an employer from deferring the accrual of benefits until an employee's later years of service in order to avoid vesting employees in their benefits. We believe that SRBs should be made available to all employees who separate from service with vested accrued benefits.

Third, the special anti-discrimination rule proposed in S. 1066 is not sufficient to assure that, in any particular year, an SRB arrangement would not discriminate in favor of employees who are owners or highly compensated. The proposed rule would not assure that the supplemental employer contributions made in a year are not disproportionately in favor of highly compensated employees. In addition, the proposed rule would not prevent a highly compensated employee who happens to retire in a year when few low-paid employees retire from receiving an excessive supplemental employer contribution. Finally, the proposed rule would not prevent the SRB contracts provided during a year from discriminating in favor of highly compensated employees. An acceptable method of providing supplemental retirement benefits outside of the benefit accrual and funding rules would have to preclude at least these forms of discrimination.

Not only does S. 1066 not contain adequate rules to prevent discrimination between employees that retire in the same year, but it also does not contain rules that would prevent discrimination between employees who retire in different years. For example, an employer would be able to offer SRBs in the years during which highly compensated employees are retiring and then cease offering the SRBs in the years during which highly compensated employees are not retiring. In addition, under S. 1066, an employer would be permitted to vary, from one year to the next, the extent to which it would subsidize the SRBs through supplemental contributions depending upon the number of highly compensated employees that were retiring. Moreover, because S. 1066 would calculate, in the year of purchase, the cap on the annual benefit increases that could be provided under all of the SRBs purchased in such year, it is inevitable that retirees who retire in different years would receive different benefit increases for the same years. We recognize that the cap would serve to control the cost of the SRBs purchased in any particular year, but the resulting differentiation between individuals who retire in different years is inappropriate.

Fourth, S. 1066 may provide highly compensated employees with an effective way to avoid the section 415 limits on benefits provided by a defined benefit plan. Because the SRB annuity should be subject to the defined benefit limits, at least to the extent that it is attributable to supplementary employer contributions, an acceptable approach would limit the employer-provided portion of the SRB payable in any year to the excess of the limit on the annual benefit payable under section 415 for the year over the basic retirement benefit payable for the year from the defined benefit plan.

Fifth, S. 1066 would not prevent benefit increases from being made under a SRB contract for reasons other than increases in the cost-of-living, so long as the proposed cap on the benefit increases is not exceeded. For example, S. 1066 would permit a SRB contract to pay increased benefits without regard to cost-of-living increases, on the basis of either a minimum benefit provision in the contract or investment experience under the contract. Although the commitment to make specified minimum increases in benefits undoubtedly would encourage employees to elect SRBs, any exception to the accrual and funding rules should be limited to benefits based only on increases in the cost-of-living.

In conclusion, the Treasury Department does not support S. 1066 because we do not believe that it is appropriate to authorize the proposed employer-provided, qualified plan benefit as an exception to the benefit accrual and funding rules. In addition, we have objections to several of the specific provisions of S. 1066 that should be resolved if an exception to the accrual and funding rules is to be considered.

S. 1550
Deduction for Foreign Taxes on U.S. Construction Services Income

S. 1550 would allow U.S. taxpayers to deduct foreign taxes imposed on income they derive for services performed in the United States in connection with a foreign construction project, while continuing to credit foreign taxes on other foreign income.

To avoid international double taxation, the United States permits its taxpayers to credit against their U.S. income tax income taxes paid to a foreign government on foreign source income. The purpose of that credit is to ensure that the United States does not tax income derived from foreign sources which has already borne a foreign tax. The credit is not intended to reduce the U.S. tax on U.S. income, and thus is limited to that portion of the U.S. tax liability which is attributable to foreign source income.

The principle of the credit and its limitation to foreign source income is that each country has the primary right to tax income arising in its territory. If that income is earned by a resident of another country, the other country may also tax the income. It is the responsibility of this other country, however, to avoid double taxation of the income earned outside of its borders, and this should be accomplished by allowing a credit for the foreign income tax paid to the country in which the income arose. Thus, limiting the foreign tax credit to foreign source income is needed to preserve for the United States its primary right to tax United States income. We accept the responsibility for avoiding double taxation of the foreign income of U.S. residents and citizens, but we do not give up our right to tax their U.S. income.

A taxpayer is entitled to claim a deduction for foreign income taxes, instead of claiming a foreign tax credit. This choice, however, is applicable to all foreign income taxes. Thus, a taxpayer may either deduct the amount of all foreign income taxes or he may elect the foreign tax credit for all foreign income taxes; he may not elect to credit some taxes and deduct others so as to minimize his U.S. tax liability by avoiding the limitation described above.

During various periods of our history, we have required taxpayers to calculate the credit limitation on a "per country" basis, that is country by country. At other times, an "overall basis" has been employed that relates the aggregate income taxes paid to all foreign countries to the aggregate income from all foreign countries. During some periods we have required taxpayers to use the lower of the two limitations and during others we have allowed them to elect either the per country or overall limitation. Since 1976 we have required the use of the overall limitation. Under this method all foreign taxes are aggregated, so high taxes in one country may spill over to offset U.S. tax on low taxed income from another country. In addition, if the credits generated in any year are too large to be fully used in that year, the excess may be carried back two years and forward five years.

This bill addresses a case where a foreign country taxes a U.S. resident on its U.S. source income. For example, a foreign country may impose a tax on amounts paid by a resident of that foreign country to a U.S. construction company for engineering services performed in the United States, but which relate to the construction of a manufacturing facility in that foreign country. Under existing law, such taxes generally qualify as income taxes, and therefore we allow U.S. taxpayers to include them in their calculation of foreign taxes which may be claimed as a credit. But for the reasons I have just noted, the credit is limited to the U.S. tax on foreign source income. Although services performed in the United States give rise to U.S. source income, the credit for foreign taxes paid on such income can nevertheless be used where the limitation I have described does not operate to prevent it -- for example where the company has foreign source income from other activities which has been subject to a lower foreign income tax than the U.S. income tax. If that is the case, the foreign tax on U.S. income can offset the tax otherwise due on the low taxed foreign income. Any excess credit may be carried back two years and forward five. If, however, the company has no other foreign income over that period or if its foreign income is continually subject to a foreign tax as high or higher than the U.S. tax, the company will get no benefit from the credit for the foreign tax on its U.S. income.

For some companies this has become a practical problem. We recognize this problem and we are sympathetic with the added burden such foreign taxes represent. We are not, however, able to support the proposed remedy, which would be to allow a deduction for such taxes.

The U.S. rule that income for services has its source where the services are performed is shared by virtually all developed countries and many developing countries. It is accepted, for example, in the model income tax treaty prepared under the auspices of the United Nations for use in negotiations between developed and developing countries. We cannot reject this longstanding and widely accepted source rule. Given that fact, a problem is presented whenever developing countries extend their taxing jurisdiction beyond the accepted international standard. The proper remedy is for those foreign countries to limit their tax on U.S. companies to services income derived within their borders.

In a tax treaty we might agree to modify our source rule in exchange for a reduced tax or other concessions by the other country. If we unilaterally undertook to mitigate the effect of excessive foreign taxes by picking up 46 percent of the cost to the taxpayer, we would encourage the use of these taxes by other countries rather than putting the responsibility on the foreign countries to cure a problem of their own making.

Moreover, while we certainly appreciate that such foreign taxes can represent a serious problem for some U.S. companies, we do not have enough detailed information to assess their impact on particular contracts or on the competitive situation in particular countries. Two examples presented to us show an additional tax cost of $1.4 million on a total contract billing of $100 million in one case and an added tax of about $0.5 million on a $40 million gross contract in the other. In the first case the service work apparently was done abroad. In the second it was done in the United States, because the company determined that it could use part of the same design work in other contracts, thus reducing overall costs. In both cases the impact of this tax could be affected by other foreign transactions the company may have undertaken. Further, we do not know to what extent foreign governments will waive such a tax in contract negotiations.

It has been pointed out that some other countries do allow a deduction for foreign taxes imposed in such circumstances. I will just note in that respect that different countries use different methods of avoiding international double taxation. Few have a credit system as generous as that of the United States in allowing an overall credit. Some countries, in addition to limiting the credit country by country, also limit it by type of income. With a credit limited to the tax on a particular piece of income from the particular foreign country imposing the tax for which credit is claimed, it may be logical to permit a choice between a credit and a deduction on the same basis, i.e., item by item, country by country. With an overall credit for all foreign income taxes on all foreign income, as our system generally has, it is logical to allow the choice between a credit and a deduction on that same basis, i.e., across the board for all foreign income taxes. Perhaps we should reconsider our credit limitation and its ramifications for different situations, but that is a major undertaking, not a project for today's consideration.

In addition, the bill, as drafted, is limited to taxpayers whose U.S. services are performed in connection with a foreign construction project. On tax policy grounds, we cannot justify targeting a benefit for this one industry. Consultants in many fields perform services in the United States for foreign clients. Conflicting source of income rules can affect other types of income as well. If we give special relief for a foreign tax on the U.S. service income of a construction company, any time a foreign country oversteps its taxing jurisdiction the precedent will be cited that the United States should unilaterally bear 46 percent of that cost.

Thus, in terms of tax policy, the bill proposes a more fundamental and far reaching change than appears to be the case from its present drafting. It amounts, in effect, to asking the United States to change its source of income rule or its limitation rule. We are not prepared to support such changes at this time. We appreciate that the affected companies are caught between conflicting tax principles and practices, but the remedy in this case must, in our view, lie with the foreign countries.

S. 1557
Elimination of Tax on Certain Interest Paid to Foreign Persons

I am pleased to have this opportunity to express to the Committee the Administration's strong support for S. 1557, which would eliminate U.S. income tax on certain interest payments to non-U.S. persons.

Description of S. 1557

Under the bill, interest payments to nonresident alien individuals and foreign corporations will be exempt from U.S. tax under the following circumstances: (1) where interest is paid by a U.S. corporation with respect to a debt obligation assumed by that corporation which, when issued, was guaranteed by a U.S. corporation and was sold under arrangements designed to ensure that the debt instruments would not be sold to U.S. persons; (2) where interest is paid outside the United States and the obligation, when issued, was sold under arrangements designed to ensure no sales to U.S. persons; or (3) where interest is paid on a registered obligation and the withholding agent has received a statement, which meets certain specifications, that the beneficial owner of the interest is not a U.S. person.

Interest will not be exempt, even if the conditions described above are met, if the recipient owns 10 percent or more of the voting power of a payor that is a corporation, or 10 percent or more of the capital or profits interest in a payor that is a partnership. Furthermore, interest will not be exempt if it is received by a controlled foreign corporation, or if it is received by a bank pursuant to a loan agreement entered into in the ordinary course of its banking business. Finally, interest is not exempt under this provision if it is effectively connected with the conduct of a U.S. trade or business.

Under the bill, the Secretary of the Treasury may remove the exemption, with respect to new obligations, for persons resident in any country which, in the determination of the Secretary, does not exchange information with the United States sufficient to prevent the evasion of U.S. tax by U.S. persons.

The bill also provides for the elimination of U.S. estate tax for holders of bonds entitled the the interest exemption.

Present Law

The Internal Revenue Code provides for a 30 percent tax to be applied to most types of interest payments to non-U.S. persons covered by the bill. In fact, because of a number of exceptions, only a small percentage of U.S. source interest payments are subject to tax at the statutory rate. In 1981, the average rate of U.S. tax on interest paid to non-U.S. persons was 2.8 percent. This figure excludes interest on U.S. bank deposits, which is exempt by statute.

Some of these exceptions are statutory. For example, the Internal Revenue Code exempts from tax interest paid to foreign persons on U.S. bank deposits, original issue discount on obligations having a maturity of six months or less, and interest paid to foreign governments, international organizations and foreign charitable organizations. The most important exceptions, however, are contained in U.S. tax treaties with more than 30 countries. Under these treaties, the United States, on a reciprocal basis, either reduces the tax on interest below the statutory rate or exempts interest from any tax by the source country. U.S. treaties with a number of our major trading partners, including the United Kingdom, Germany and the Netherlands, exempt interest from tax by the source country. Our treaty with the Netherlands Antilles also provides for this exemption, and has become the principal vehicle for borrowings by U.S. companies in the Eurobond market on a tax-free basis.

Discussion

The Administration believes that access to foreign capital markets is an important element in achieving increased capital formation and sustained economic growth in this country. S. 1557 would improve access to these markets for American business.

The nature of the Eurobond market is such that access on a competitive basis requires that interest be paid free of tax in the source country. Such tax-free access is now generally possible through the careful use of the statutory and treaty exemptions. To gain such access, however, American companies frequently must employ costly and complex mechanisms. Most often a financing subsidiary in a treaty-protected jurisdiction, such as the Netherlands Antilles, is interposed between the American borrower and the foreign lenders in an effort to eliminate the 30 percent U.S. tax on interest. Uncertainty now surrounds the U.S. tax consequences resulting from the use of these structures. S. 1557 would eliminate this uncertainty and would permit Americans to borrow directly in these capital markets, thus obviating the need to create and utilize these "back-door" routes. S. 1557 is carefully structured to provide this access to the Eurobond market in a simple, straightforward manner, while guarding against the possible use of these provisions by U.S.

persons to evade U.S. taxes. We do have a few technical suggestions on the drafting of the bill, and we would be pleased to work with your staff on these issues.

Revenue Effects

We anticipate that S. 1557 will result in an increase in revenues in an amount which will exceed $35 million. At present, there is widespread use by American companies of Netherlands Antilles finance subsidiaries for issuing Eurobonds. These finance subsidiaries are subject to a tax in the Antilles which the U.S. parent may claim as a foreign tax credit against its U.S. tax. The credits being claimed exceed, by a substantial amount, the tax collected on the interest payments to foreign persons which would be exempt under S. 1557.

S. 1666
Special Capital Gain Treatment for New Issues of Corporate Stock

Background

Under current law, corporate stock held for investment is treated as a capital asset, and gain recognized on the sale or exchange of such stock is "capital gain" subject to favorable tax treatment. An individual is taxed on only 40 percent of his net capital gain. As a result, this gain is taxed at rates that are 40 percent of the rates of tax imposed on other income. For example, while the maximum rate of tax on income of individuals is 50 percent, the maximum rate on net capital gain is 20 percent. Net capital gain subject to this special treatment is the long-term capital gain recognized during the taxable year net of any long-term capital loss, reduced by the excess, if any, of short-term capital loss in excess of short-term capital gain.

Description of S. 1666

S. 1666 would reduce the rates of tax on certain capital gain by up to 50 percent. Under the bill, only 20 percent of certain gain recognized by individuals with respect to new issues of corporate stock would be subject to tax. Therefore, the maximum rate of tax on qualifying capital gain generally would be 10 percent. The gain would be subject to the alternative minimum tax, however, and in certain circumstances could be taxed at a rate of up to 20 percent. The reduced rate of tax would apply to net capital gain recognized with respect to qualified stock held for 5 years or longer. Qualified stock would be stock held by an individual investor who purchased the stock when it was originally issued.

The bill would apply to sales or exchanges after December 31, 1983.

Discussion

The purpose of S. 1666 is to increase the rate of capital formation in the United States, particularly for new growth companies. Although the Treasury is sympathetic with this goal, we must oppose S. 1666. First, we believe the goal of an increased rate of capital formation could be achieved more efficiently by a comprehensive elimination of those features of our current tax system which impede capital formation. Consequently, we cannot support granting special tax benefits only to newly issued corporate stock. This targeting, although generally intended to offset perceived impediments to capital formation, would be relatively inefficient and would lead to changes in economic behavior that concern us. Additionally, as drafted, the bill would have a number of undesirable consequences that are unrelated to the stated purposes of the bill. Finally, S. 1666 would cause a significant revenue loss.

Effect of Granting Special Benefits for Newly Issued Stock

The bill would distinguish between newly issued corporate shares and all other forms of saving and would grant special tax benefits only to the newly issued shares. This would change economic behavior in at least three ways. First, by decreasing the relative rate of tax on businesses that use new capital, the bill would direct economic activity away from the relatively higher taxed service industries and other industries that do not require new capital. Second, by providing an incentive only for new issues of corporate stock, the bill would change investment patterns. Funds would be attracted away from other investments to new shares which offer increased after-tax returns. With total capital supplies largely fixed in the short term, a greater allocation of capital to new corporate stock would mean a reduced availability and higher cost of capital for businesses that do not issue new stock. For example, businesses would be required to pay higher rates of interest on borrowings. Third, S. 1666 would encourage the incorporation of a business to secure the tax benefits available for new corporate shares in instances where the business would not be conducted in corporate form if tax considerations were neutral.

In addition, there is little economic justification for linking reduced tax rates to a 5-year holding period. The tax law generally does not tax the appreciation in value of capital assets until that gain is recognized through a sale or other disposition of the property. Thus, under the present system of taxation, there is a benefit from holding assets for long periods of time; the tax attributable to increases in value that occurred during the earlier years is deferred and, therefore, reduced in present value terms. Inflation, of course, offsets the benefit of deferral to some extent since the gain subject to tax will exceed the taxpayer's inflation-adjusted gain. However, taking the effects of both deferral and inflation into account, the effective rate of tax on gains accrued evenly over a 5-year period and taxed at the end of that period is less than on gains accrued during one year and taxed in that year. Consequently, a decreased rate of tax generally should not be linked to a longer holding period. Moreover, the 5-year holding period requirement would encourage investors to hold qualified stock for at least 5 years, and would lead to inefficient economic decisions.

Finally, the 5-year holding period requirement for new issues creates distinctions among otherwise identically situated taxpayers that could be regarded as unfair. For example, two individuals might purchase shares of X Company on the same date, one buying new shares and the other buying old shares. There does not appear to be a sound reason for subjecting the latter individual to a rate of tax that is twice that imposed on the former.

Unintended Effects

While S. 1666 is designed to promote capital formation, it would have a variety of unintended and undesirable effects. As drafted, the benefits of S. 1666 apply to any new stock issue. Approximately 80 percent of new corporate stock issues are sold by established corporations. Consequently, these companies would be the principal beneficiaries of S. 1666, not the young, growth companies the bill intends to benefit.

The bill also would apply to new shares even though they do not represent new capital. The benefits of the bill would be available where a corporation issues new shares to finance market acquisitions of its old shares. Obviously, no new equity is created in such a transaction. Corporations would have a strong incentive to enter into such churning transactions. The tax advantaged new shares would sell for a price higher than the selling price of the old shares. Since no gain or loss is recognized on the purchase or sale by a corporation of its own shares, companies would realize substantial tax-free profits. The source of these profits would be the tax revenue foregone on the new stock entitled to the benefits of S. 1666.

The benefits of S. 1666 also would be available for a variety of investments that do not represent new capital for corporate businesses. The reduced rate of tax on capital gain generally would be available for any asset that can be incorporated. For example, an investor could transfer any type of appreciated property to a new corporation in exchange for new stock, sell the stock after 5 years when he wishes to sell the property, and secure the benefits of S. 1666 for what is no more than an investment in the previously-owned property.

While it might be possible to alleviate some of these problems with appropriate anti-abuse provisions, any effort to define and trace shares attributable to new capital will present significant difficulties.

The effective date provision of S. 1666 also has undesirable effects. The bill applies as of January 1, 1984 to all new issues of corporate stock that have been held for over 5 years. Consequently, the benefits of S. 1666 would be available immediately to stock issued at least 5 years earlier. This stock does not represent new capital in any sense, and yet would receive favored tax treatment under the bill.

Finally, our analysis indicates that many sellers of S. 1666 stock would be subject to the alternative minimum tax. S. 1666's reduced rates would not apply in these cases and gain on qualified stock would be taxed at 20 percent. This minimum tax effect would reduce the incentive effect of the bill, as taxpayers would anticipate the possible imposition of the minimum tax, a negative factor in deciding whether to buy S. 1666 stock. Alterations to S. 1666 to eliminate the effect of the alternative minimum tax on this gain would more than double the estimated revenue cost of the bill.

Effect on Federal Revenues

Our estimates indicate that the bill would result in a significant decline in Federal revenues, notwithstanding some increased sales of stock as a result of the lower rate of tax.

Conclusion

In conclusion, it is important to remember that the Economic Recovery Tax Act of 1981 reduced taxes on all forms of business enterprise in order to increase economic efficiency and stimulate productivity and growth. These tax reductions are now in place and working. In contrast, narrow approaches to capital formation, such as S. 1666, are likely to be relatively ineffective since narrow approaches inherently create economic distortions. As budgetary constraints permit, we look forward to working with the Congress on comprehensive approaches to reform in order to optimize capital formation and long-term economic well-being.

Senator **Chafee**. Next will be a panel consisting of Mr. Wellington, Mr. McMurtry, and Mr. Reenie. And that will deal with S. 1666, which Mr. Chapoton shot down, or attempted to shoot down. [Laughter.]

Why don't you start off, Mr. Wellington. We will take all of these panels in the order that they are listed.

We welcome each of you here. Now, the testimony will have to be 5 minutes. And try to restrict it to that. I will remind everybody in the room, as you probably know already, your written testimony as submitted will go in the record. We'll have a chance to review it here. If you can summarize, it will help us, because this session is going to be broken up by a series of rollcall votes which always take much longer than we think.

Mr. Wellington, I'm glad you're here, won't you proceed?

STATEMENT OF ROGER D. WELLINGTON, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, AUGAT, INC., MANSFIELD, MASS., ON BEHALF OF THE AMERICAN ELECTRONIC ASSOCIATION, WASHINGTON, D.C.

Mr. **Wellington**. I am Roger D. Wellington, chairman of the board and chief executive officer of Augat, Inc., a Massachusetts based manufacturer in the electronics industry. In the last 10 years our sales have grown by a factor of 14, increasing employment from 350 to 3,400 people, plants in eight States and we have wholly-owned marketing subsidiaries in eight foreign countries.

I am appearing before you today on behalf of the American Electronics Association which now represents approximately 2,300 members nationwide, encompassing all sectors of the electronics industry. Our companies account for approximately 63 percent of the world sales of the U.S. based electronics industries.

We welcome this hearing as a positive vehicle to encourage further serious consideration of incentives for investors in high technology companies. You, Senator, have been an active ally of the U.S. high technology industry for a number of years, considering particularly the 1981 Tax Act on reforming the taxation of Americans abroad, your policies to promote high growth industries on which I had the honor to testify last January, and we do recognize that this bill has been introduced in a similar effort to improve the tax treatment of investors in high technology companies.

We have examined in detail your Senate bill 1666, have had a number of our company executives review this, including our board of director's Steering Committee on Capital Formation, the Taxation Subcommittee of our Government Affairs Committee, and by an ad hoc group of electronics companies who are currently preparing a major study of our industry's tax priorities. There was substantial agreement on the position which I am summarizing.

We know that this proposal is in no way intended as a competitor to the bills you have also sponsored to remove the sunset on the R&D tax credits, and our members feel it is important for us to repeat here that making the R&D tax credit permanent continues to be our industry's top domestic priority in this Congress.

We strongly feel that the bill's basic approach to improve incentives to stimulate the process of innovation in U.S. technology, which responds much better to tax incentives than a direct Federal spending program. Most of our companies are paying a relatively high effective tax rate, they are generally not oriented toward seeking direct Federal subsidies.

The problems that we see with the bill, although we don't oppose the bill and we appreciate its excellent goals, so far has been that the high technology industries can expect Congress to direct only a limited amount of Federal revenue in their direction for the next few years, and this bill wouldn't use that revenue as effectively as a number of other approaches might.

This reaction stems primarily from the lack of difficulty our companies, including many newly-formed startups, have been recently experiencing in marketing their new stocks. We grant that this situation could change, but at present, however, difficulties they are having in this area don't compare to their other problems such as finding adequate engineering talent.

Our executives feel that a further 10 percent reduction in the capital gains tax rate is not sufficient to offset the greatly increased risk to the investor that results from being locked into an investment for an additional 4 years.

We have also turned up some technical drafting problems. Should the bill progress further, we would be happy to discuss these in detail with your staff.

We would, however, like to suggest serious consideration of some alternatives. As I mentioned, our industry has been focusing on making the R&D tax credit permanent and enacting incentives for companies to help train more engineers.

We will mention some potentially positive concepts for encouraging further investments by individuals. Although we do not have a consensus to report to you yet, there are some alternatives which we are considering. Amongst those would be:

A "rollover" of investment in equities. Under this plan, investors would be taxed on their investment in common stock when the stock is sold, only if the proceeds from the sale are not reinvested in other common stock within a relatively short time.

Senator **Chafee**. You wouldn't limit that to small businesses?

Mr. **Wellington**. No, sir.

Senator **Chafee**. As you know, this has been a small business proposal for many years before this committee. We haven't gotten very far with it. I think it's a No. 1 priority of the Small Business Association and groups, and we have great trouble doing that.

Why don't you give us the next one?

Mr. **Wellington**. The indexation of capital gains. I believe that was addressed in some other testimony, so I won't detail that.

And then we are developing some positions relative to deductibility, even when deferred, of dividends on perhaps a new class of preferre, stocks.

Finally, for the longer term, we hope you will consider moving our fiscal system away from taxing capital, savings, and investment toward a system that taxes consumption.

So in conclusion, Mr. Chairman, we would like to express our appreciation for all you have done and are doing to facilitate the emergence of the U.S. high technology industry, and we think your request for our testimony demonstrates an unusual and admirable commitment to report to the floor legislation that actually accomplishes its stated purpose. And we would look forward to working with you further on this important issue.

Senator CHAFEE. Well, thank you very much, Mr. Wellington.

[The prepared statement of Roger Wellington follows:]

Statement of Roger D. Wellington
on behalf of the American Electronics Association
before the Savings, Pensions and Investment
Policy Subcommittee of the
Senate Committee on Finance

September 19, 1983

Mr. Chairman and Members of this distinguished Committee;

Good morning. I am Roger D. Wellington, Chairman of the Board and Chief Executive Officer of Augat Inc., a Massachusetts based manufacturer and designer of a broad range of electromechanical interconnection products, services and precision materials for the electronics industry.

In 1972 Augat was an early member of the emerging New England based electronics industry with annual sales of $14,000,000, 350 employees, and two plants in Attleboro and Mashpee, Massachusetts. In the ensuing decade, the company's revenues have grown thirteen-fold with 26 plants, employing 3,400 people in Massachusetts, Rhode Island, New York, New Jersey, Florida, Illinois, Texas, California and Switzerland. During that time, Augat wholly-owned marketing subsidiaries have been established in Great Britian, France, Germany, Sweden, Italy, Switzerland, Canada and Japan.

I am appearing before you today on behalf of the American Electronics Association. AEA now represents over 2,300 member companies nationwide, and over 450 financial, legal and accounting organizations which participate as associate members. AEA encompasses all segments of the electronics industries including manufacturers and suppliers of computers and peripherals, semiconductors and other components, telecommunications equipment, defense systems and products, instruments, software, research, and office systems. The AEA membership includes companies of all sizes from "start-ups" to the largest companies in the industry, but the largest members

(80%) are small companies employing fewer than 200 employees. Together our companies account for 63% of the worldwide sales of the U.S. based electronics industries.

I. Introduction

Mr. Chairman, we very much appreciate your requesting our views on S.1666 which aims to assist high technology companies by lowering the maximum capital gains rate to 10% for the first holder of an original stock issue. We welcome this hearing as a positive vehicle to encourage further serious consideration of incentives for investors in high technology companies.

You have been an active ally of the U.S. high technology industries for a number of years. We continue to remember and applaud your leadership in reforming the taxation of Americans abroad in the 1981 tax act; your illuminating and productive hearings this past January on federal policies to promote high growth industries (at which I was honored to testify); and your sponsorship, with Senator Bentsen of S.1195, our industries' proposals to combat the severe shortage of electrical and computer engineers facing the U.S. today. We recognize that today's bill has been introduced in a similar effort to improve the tax treatment of investors in high technology companies, and we appreciate your continuing efforts on our behalf.

II. AEA's Analysis of S.1666

Though the time to prepare for this hearing has been short, we have been able to have this proposal examined in detail by enough of our member company executives that we are confident of our report to you of their views. The bill was considered and discussed this past week by the AEA board of directors steering committee on capital formation, the taxation subcommittee of our government affairs committee, and by an ad hoc group of electronics companies who are currently preparing a major study of our industry's tax priorities for the years ahead. There was substantial agreement on the following points among each of those groups.

First, though we know this proposal is in no way intended as a competitor to the bills you have also sponsored to remove the sunset on the R&D tax credit. Our members feel it is important for us to repeat here that making the R&D tax credit permanent continues to be our industry's top domestic priority in this Congress.

A. Support for the goals of S.1666

We can report to you that our members find much to commend in S.1666. We strongly agree with the bill's basic approach to improve incentives to stimulate the process of innovation in the U.S. High technology companies respond much better to tax incentives than to direct federal spending programs since they have relatively high effective tax rates and generally are not oriented toward seeking direct federal subsidies.

We also agree with the bill's strategy of assisting high technology companies by improving incentives for individual investors. AEA's 1978 study of the capital formation experience of the U.S. electronics industries documented that these companies have a continuing need to go into the capital market for new infusions of risk capital investment. If there had been any question before, the spectacular success of the 1978 and '81 reductions in capital gains tax levels in generating new investor support for high technology companies has certainly settled that question.

Finally, we generally favor incentives for longer term investment, and appreciate this bill's efforts to improve those incentives.

B. Problems with the specific approach to S.1666

Having said all this, we are still forced to report to you that we were unable to detect much support for this bill among our members. They certainly don't oppose the bill, and appreciate its excellent goals, but the net reaction so far has been that the high technology industries can expect Congress to direct only a limited amount of Federal revenue in their direction for the next few years and this bill wouldn't use that revenue as effectively as a number of other approaches might.

This reaction stems primarily from the lack of difficulty our companies (which include many newly founded "start-ups") have felt recently in marketing their new stock issues. We grant that this situation could change any time, but at present, whatever difficulties they're having in this area don't compare to their other problems such as finding adequate engineering talent.

Our executives feel that a further 10% reduction in the capital gains tax rate is not sufficient to offset the greatly increased risk to the investor that results from being locked into an investment for an additional four years.

For example, consider a hypothetical investor who invested in an electronics company and has earned a $1000 gain after one year. If he sold immediately and paid a 20% capital gains tax he would realize $800 net. Under this bill he must decide whether the additional $100 he could gain by leaving the money invested is worth the extra risk he would incur by being locked into the volatile high tech market for four more years.

Even if this investor sold after one year and put his $800 into a tax free money fund paying 6% compounded, he could earn $209.98 with very low risk instead of the extra $100 this bill would provide. Of course the possibility of a much higher gain on the investment might keep investors from selling after one year, but what goes up also comes down and it's not clear to us this bill's incentive would play a very large role in the continuing investment decision for many high tech investors.

A five year investment period may well be attractive to venture capitalists who have traditionally waited at least that long to liquify their investments, but our company presidents and tax specialists saw no other class of likely beneficiaries in the high tech field from this bill.

We also turned up several technical drafting problems that would need to be addressed to allow the bill to perform its' intended function. We will be happy to review these in detail with your staff.

III. Alternatives

Mr. Chairman, we welcome this bill and this hearing as positive vehicles to encourage further serious consideration of incentives for investors in high technology companies. As I mentioned, our industry has been focusing recently on making the R&D tax credit permanent and enacting incentives for companies to help train more engineers. Accordingly, though we will mention some potentially positive concepts for encouraging further investment by individuals, we do not have a consensus to report to you yet on which alternative AEA would recommend above the others.

We would however recommend that this Committee consider proposals involving:

(1) A "Rollover" of Investment in Equities. Under this proposal investors would be taxed on their investment in common stock when the stock is sold only if the proceeds from the sale are not reinvested in other common stock within a relatively short period of time (*e.g.*, 30 days).

(2) The Indexation of Capital Gains. Under this proposal a taxpayer's basis in stock (and any other eligible assets) would be adjusted upward for inflation annually, reflecting the actual rates of inflation incurred in specific years. Upon the sale of stock, the gain taken into account by the shareholder would be reduced by the cumulative amount of inflation attributable to his or her shares since their acquisition.

(3) Deductions for Dividends Paid on New Stock Issues. Under this proposal deductions for dividends paid on any new class of stock would be permitted. One type of stock which could be issued would be a modified type of preferred stock. Holders of this stock would receive a specified level of dividends to the extent earnings permit but would also be permitted partial or full participation in the future appreciation of the value of the company. If the likelihood of appreciation is substantial, investors in this type of stock might be willing to take the uncertainty of not getting a current return in bad years and still settle for a dividend payment which is substantially lower than current interest rates. Moreover, companies might be able to issue this type of stock when they cannot or prefer not to issue debt, since the direct current costs (after-tax) would be less than debt, and since payments could be curtailed or eliminated in poor performance years.

Finally, for the longer term, we hope you will consider moving our fiscal system away from taxing capital, savings and investment toward a system that taxes consumption.

Conclusion

Mr. Chairman, let me repeat our appreciation for all that you have done and are doing to facilitate the emergence of the U.S. high technology industries. We think your request for our testimony on this bill--even after you knew of our conclusions--demonstrates an unusual and admirable commitment to report to the floor legislation that actually accomplishes its stated purpose. We look forward to working with you further on this important issue.

Senator CHAFEE. I must say this is a model of tactfulness, this statement. It is thanking me, but it's a lousy idea I've got.

[Laughter.]

Senator CHAFEE. Which is all right. We won't spend our time on things that aren't helpful.

All right, let's go to the National Venture Capital Association and Mr. McMurtry.

STATEMENT OF BURTON McMURTRY, DIRECTOR, NATIONAL VENTURE CAPITAL ASSOCIATION, MENLO PARK, CALIF.

Mr. MCMURTRY. Thank you, Mr. Chairman.

My name is Burt McMurtry. I am with the National Venture Capital Association. I am a partner in a venture capital company in Menlo Park, Calif. I have been in the venture business since 1969 and spent 12 years in a technology business in engineering and management before that.

We are strong supporters of this bill.

We think that the bill speaks to some real concerns of the industry, and in particular the need for two things: One, a long-term orientation toward investing and a focus on direct investments in operating companies. I am a personal witness to the impact of the capital gains tax law changes in 1969, 1978, and 1981. I can tell you as a personal participant something that I think we all know, that this country was absolutely capital-starved when it came to availability of capital for small companies, their availability of capital, during most of the 1970s. That has changed dramatically, and we assign a lot of the reason for that to the change in the capital gains tax in 1978 and 1981.

One could ask, is it so well fixed now that one doesn't need to do anything differently? I think the answer is no. I think anything we could do to increase incentives for direct investments in companies to be held for a long period of time would in fact help that process along. I really don't agree with Congressman Zchau on his thought that this would in fact restrict the flow of capital. I think what we want to do is to encourage the flow of capital particularly into young businesses. I think they will get their share of this capital if this bill goes through. We want to encourage them to hold it for a long period of time.

I don't believe, the way the bill is drafted, that one would be locked in to this. Rather, one would have the opportunity to have the benefit of this reduced tax if one chose to hold the asset for the full 5-year period of time. On the other hand, if one decided not to hold for that time period he would in fact be free to sell the asset under existing capital gains treatment rules.

One question I would like to address briefly is whether or not there is already too much money in this business. The amount of money that has flowed into the business in the last few years has been dramatic; I wouldn't have believed that it could occur. And in fact, trying to view that from the 1975-76 or 1977 perspective, if someone had said there is going to be a billion-six going into this venture capital business in the last year, I would have said that's too much money. There wouldn't be places to put it.

What I have observed, again, as a front-line participant in this business, is that both the quality and quantity of investment opportunities have gone up dramatically, and I think there is a simple reason for that is entrepreneurs are among the smartest people around. If capital is essentially impossible to raise, only the die-hards will be out there trying to do it. And when capital is considerably more free and more available, would be entrepreneur will in fact come out of the woodwork to start businesses. We think that is an enormously constructive thing.

The impact on this nation's competitiveness, the impact on job creation is so great that we think it would be foolish to pass up an opportunity to a further reduce the capital gains tax, particularly when it is oriented toward a reasonably long holding period and toward direct investment.

I am sure there are important technical issues in connection with this bill that may need to be addressed. People on our staff would be very happy to try to work with you or those issues to the extent that we could be helpful.

We would like to lend our support and believe that we are providing that support from a basis of some experience in this industry that tells us we need this kind of effort.

Thank you.

[The prepared statement of Burton McMurtry follows:]

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STATEMENT OF

BURTON J. McMURTRY

General Partner
TECHNOLOGY VENTURE INVESTORS

and

Chairman
Incentives and Tax Committee; and

Member
Board of Directors
NATIONAL VENTURE CAPITAL ASSOCIATION

before the

UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Savings, Pensions, and Investment Policy

September 19, 1983

Mr. Chairman, my name is Burton McMurtry and I am a General Partner in Technology Venture Investors (TVI), a private venture capital firm based in Menlo Park, California. TVI has a capital base of $70 million and has to date provided financing to 32 companies, the vast majority of which fall into a category commonly referred to as high technology.

I hold both Masters and Doctorate Degrees in electrical engineering. Prior to my entry into the venture capital business in 1969, I had extensive management experience with GTE Sylvania.

I serve as a Member of the Board of Directors of the National Venture Capital Association, and Chairman of the NVCA Incentives and Tax Committee. It is on behalf of that 144-member organization that I appear before you today.

Mr. Chairman, I would first like to commend you for calling these hearings and for introducing S. 1666, the Capital Formation Tax Act of 1983. Your measure is fully responsive to the concerns that our association representatives and other witnesses raised during the Finance Committee hearing which you chaired last January. The five venture capital expert witnesses explained at that time the need for legislation which would reduce the maximum capital gains tax for taxpayers purchasing securities issued by an emerging or small business and held for an extended period of time, similar for instance to legislation signed into law last year in California. For the sake of brevity I will not reiterate all of those reasons again today. I would, however, like to make clear that S. 1666 speaks to an issue that has been addressed in numerous forums and studies in the last several years. For instance, the 1980 White House Conference on Small Business addressed the need for revising the capital gains tax to help spur more equity investing in small business. The SEC Government-Business Forum on Small Business Capital Formation held in September, 1982 -- just a year ago -- made the following recommendations: "Congress should amend the Internal Revenue Code to provide that after holding an equity or equity-type investment made directly in a small business for more than five years, the seller of such an investment would be entitled to exclude 80% of any gain realized on such investment."

In a report released this summer by the Heller Small Business Institute entitled, "Entrepreneurship and National Policy," the third priority recommendation read: "Drop the capital gains tax to zero on money invested in a start-up or a very early stage company and left in a business for five or more years." Each of the so-called "Big Three" generic based national small business organizations have included in their legislative priorities recommendations urging that the capital gains tax be altered to benefit new and existing smaller companies. In some cases these and other organizations, along with NVCA, have urged the adoption of a capital gains "rollover" provision in addition to pressing for a reduction in the maximum tax if a small business security is held for several years as opposed to several months.

My list of endorsements of those urging action in the capital gains area to foster entrepreneurship is by no means exhaustive, but it is meant to be indicative of the depth and breadth of support that exists for the type of legislation which you and other members of the Finance Committee have introduced. Suffice it to say that multiple venture capital and small business interest groups are supportive of this kind of measure because it brings the reward side of the equation more in line with the risks attendant to making illiquid investments in untried, unseasoned, but promising innovative companies. It is terribly important to remember this point when considering legislation such as S. 1666. The greater the reward, the greater the risk taking, and it is the combination of these two factors that fuel the innovative process.

I believe the most constructive contribution I can make this afternoon is to speak to observations that have been made or questions that have arisen since the July 21st introduction of your bill.

First, with all the publicity that has been generated in the last few months on the subject of venture capital, one might be left with the impression that the country is awash with venture capital funds, that too much money is chasing too few deals, and that some of the deals being financed are really not meritorious nor probably economically viable for the long haul. I want to politely, but firmly disabuse everyone from these ideas for, although the climate for venture investing has never been more favorable, there is still a major equity capital short-fall.

In August, 1982, the General Accounting Office in its report to Congress on the state of venture capital, estimated there was an estimated venture capital shortfall in 1980 ranging between $5.5 billion to $13.5 billion. Mr. Stanley Pratt, a nationally recognized authority on the venture capital industry who appeared before you last January, stated in the July, 1983 Venture Capital Journal: "With demand continuing to exceed supply and future requirements being driven up by new business formations in which the successful companies will need ongoing expansion financing, the shortfall gap over the $7.6 billion in professional venture capital resources at the end of 1982 was probably greater than in 1980."

Since the total assets of all formally organized and managed venture capital firms is now approaching $8 billion, the Pratt figures suggest the venture community needs to double its asset size before it would begin to adequately meet the demand for funds by new and emerging businesses. And in making that statement, I am implying that I seriously doubt another $7-8 billion in venture funds would quench the appetite for our type of resources. Why? Because, ten years ago no one envisioned that there could possibly be a sufficient number of start-ups or expanding, innovative concerns that could productively use $7-8 billion in funds.

Furthermore, thanks principally to the two-staged reduction in the maximum capital gains tax rate beginning in 1978, all kinds of would-be entrepreneurs have come out of the woodwork with exciting, worthwhile proposals that are as deserving of as much consideration as those relatively few deals to which we were exposed in the 1970's. And in so doing, we have not witnessed any noticeable fall-off in the caliber of the proposals being submitted to our member firms.

The driving force behind this entrepreneurial resurgence is the lower capital gains rate. If would-be entrepreneurs, inventors, or founders do not believe there is a reasonable prospect of obtaining funding for their ideas or fledgling businesses, they simply will not attempt to strike out on their own, and that is the country's loss as it dampens the innovative spirit and makes for a less competitive marketplace.

A lack of venture capital is difficult to demonstrate in that the problem is similar to identifying and quantifying the functionally and structurally unemployed. After looking for a job for many months, a person out of work ceases to become a statistic in that he or she is not counted as being among the "unemployed" even though they have not found a job. Thus, the larger the formal and informal venture capital pool, the greater the likelihood prospective founders will take the plunge and attempt to organize and capitalize the future IBMs, Polaroids, Xeroxs and Hewlett-Packards.

As to the charge that we are financing situations that do not deserve support, let me suggest that such an opinion is subjective at best and might even reflect a bit of sour grapes on the part of some CEO's whose companies have witnessed employees leaving to undertake projects in less bureaucratic, more free-wheeling, innovative environments, namely their own companies. After all, how many people less than a decade ago foresaw the need for a guaranteed overnight package/letter delivery service? One chap did, and he in turn convinced a group of venture capitalists that the idea had merit. As a result, Federal Express was born and in so doing has revolutionized how this country transports critical written communications and goods. I would suggest, Mr. Chairman, that we are today financing people whom many may believe unworthy, but after the passage of time will be hailed as imaginative, bold entreprenrurs who pioneered new applications of recently discovered technologies.

Recognizing that there still exists within the independent business sector an insatiable demand for equity funds, will S. 1666 help meet this need? Our answer is an unequivocal, YES! Some have suggested that the bill is not sufficiently narrow enough in its focus. I submit the legislation could be redrafted so only a very small, targeted group would benefit, but I believe it would require a trade-off that would be unacceptable from a public policy point of view. Difficult, if not insurmountable problems, would be encountered in trying to define the intended beneficiaries such as companies in the "high technology area." Even if a definition could be agreed upon, many would fail to be enticed by this new tax "carrot" because they would be uncertain whether the company qualified. There is enough uncertainty in the tax and other regulatory areas already; we do not need to compound the problem with overly complicated, unworkable definitions.

Another problem is how does one accurately identify the appropriate group who is to benefit from a more narrowly defined provision. There are lots of informed opinions as to the "what", "when", and "where" of how new productivity enhancing industries will arise, but many will be proven wrong over the course of the next several years.

As a matter of fact, that is what venture capital is all about. We bet on companies which we hope will be big winners six to twelve years from now, but more often than not we miss the mark. Thus, I firmly believe the eligibility standard for the ten percent tax rate needs to be as broad as possible.

There is another added benefit by not imposing a size standard in your bill. Only a year ago there were cries of alarm because many of America's largest corporations had abnormally high debt-to-equity ratios. Although it is not our role to make the case for these concerns, to the extent this measure serves to bring those ratios into a healthier alignment, so much the better. Many of our portfolio companies after all are suppliers to, and therefore dependent upon the continued viability of these larger companies.

We do make the case, however, that even though technically untargeted, emerging companies will disproportionately benefit if this measure is enacted. That was the case with the 1978 and 1981 reductions and we have every reason to believe such a phenomenon will occur again with S. 1666. Data from Venture

Economics illustrates this point. In 1980, 66 percent of the companies assisted were engaged in the manufacturing of goods or production of services that would improve productivity. In 1981, that figure increased to 75 percent.

All of these technology related investments, of course, help to create new jobs, make us more competitive abroad, and will ultimately pay rich dividends in terms of taxes paid to federal, state and local governments. Again, those attributes were addressed in some depth at the previous hearing, but the positive revenue feedback to society bears repeating.

A detailed analysis done for the Ways and Means Committee in 1978 concluded that for every $1.00 invested by a venture capital firm in a small company, five years later that company will begin paying an average of 35 cents each year in federal, state and local taxes, allocate 33 cents in research and development expenditures, and will generate 70 cents in export sales.

GAO figures are even more astounding--$209 million invested in 72 companies between 1970 and 1979 produced:

130,000 jobs;
$100 million in corporate tax revenues;
$350 million in employee taxes; and
$900 million in export sales.

It is important to bear in mind that GAO did a random sample survey. We therefore have every reason to believe that similar benefits are accruing with the almost $8 billion we currently have at work throughout the United States.

Since this Committee has been particularly interested in encouraging innovation, I would like to refer to another very important statistic buttressing the importance of making equity capital as accessible as possible to the small business sector. GAO projects that for every $1,000 in venture funds invested in the 1970's, an estimated $40,000 to $54,000 worth of productivity enhancing products and services will be sold in the 1980's. Given our present resources, that experience translates into staggering, mind boggling figures for the 1990's.

There is one other matter we feel the need to address and that is, can we afford such a measure during a time of record high deficits and when both tax writing committees have been instructed to find additional revenue sources. Given the dynamic revenue feedback which I cited above, the more appropriate question is, can the Congress afford not to enact in a timely manner the Capital Formation Tax Act of 1983?

Even using a static revenue analysis, does the government lose money? Data delivered by the Chairman of the Council of Economic Advisors in a speech in April suggests Uncle Sam makes money. There follows two excerpts from Mr. Feldstein's remarks:

> The CEA analysis of tax return data shows that reported net long-term gains more than doubled between 1977, the year before the tax change, and 1979. Net long-term gains less net long-term losses rose from $30.3 billion in 1977 to $63.8 billion in 1979, up 111 percent.
>
> Tax data for 1980 show that the level of realized capital gains remained high in that year, with net long-term gains less net long-term losses equal to $65.3 billion. This indicates that that doubling of

> reported gains between 1977 and 1979 was not caused by taxpayers postponing gains that would otherwise have been realized in 1978 and 1979.

Treasury, on the other hand, predicted in 1978 and again in 1981 that the two capital gains initiatives contained in the pending omnibus tax bills would generate losses in those years immediately following enactment. Incontrovertible Treasury evidence now shows those losses did not occur and thus I would view with extreme skepticism any revenue analysis that projects a loss if S.1666 were to be enacted.

Before closing, I would like to make one technical suggestion. In that section of the bill that defines the term "qualified issues of stock", Part (A) of the definition refers to "initial stock offering." Many people have interpreted that phrase to mean only those securities offered by a corporation when it has its first public offering. If I understand correctly, Mr. Chairman, the intent was to qualify any equity security offered by a company as long as the company receives most of the proceeds from the sale and the securities are held for at least five years. To cure this problem we would suggest that the words, "through an initial stock offering" on lines 9 and 10 of page 3 of the bill be deleted.

Part (C) of that same definition is also too restrictive in that there is virtually never an offering where the company is the recipient of all the proceeds of the offering. Existing shareholders such as founders and investors, broker-dealers, lawyers and accountants may all receive a portion of the funds raised. If allowance is not made for these circumstances, few, if any, securities will every qualify for the preferential treatment provided in S. 1666.

Mr. Chairman, thank you again for the opportunity to appear today and register our enthusiastic support for your bill. We hope the Finance Committee will see fit to report S. 1666 in the near future.

Senator **Chafee**. Well, I will say, Mr. McMurtry, that the testimony of Mr. Wellington, as it is on behalf of the AEA, carries a lot of weight. So I would think that if we tried to press ahead here, AEA's position would be thrown up contrary to the views you have expressed, and the views that I previously thought were popular both with the AEA and, of course, with the venture capital people. But if the AEA has taken the position that they have, it would be quite difficult to press ahead with this legislation, in my judgment.

Mr. **McMurtry**. I understand that. I wish we had some more experience with the act that was passed a year ago in California that in fact provides a reduction in capital gains tax for interests held more than 3 years, and is directed toward small companies. But we just don't have the history as yet.

Senator **Chafee**. I should think it might be so insignificant as part of the total vis-a-vis the Federal income tax that it wouldn't make that much difference.

All right. Mr. Rennie?

STATEMENT OF JOHN C. RENNIE, PRESIDENT, PACER SYSTEMS, INC., BURLINGTON, MASS., ON BEHALF OF THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, WALTHAM, MASS.

Mr. **Rennie**. Thank you, Mr. Chairman.

I appreciate very much the opportunity to testify today. I am here as president of the Smaller Business Association of New England, with 2,000 members and virtually all industries in New England, as President of Small Business United, a more or less national group covering three dozen States and 60,000 companies, and also as president of a smaller high technology company manufacturing aviation, electronics equipment, and also professional services in the same field.

In these capacities and since I started my own company in 1969, in virtually every meeting between small businesses, owners and managers especially, the primary area of concern has been access to capital. You reflected on this earlier, Mr. Chairman, and this is still true; it was reflected—we have testified here over the years many times on behalf of SBANE; the White House Conference on Small Business in 1980 echoed the same thing; Small Business United in its annual meetings here and in various symposia have echoed it again.

We look at this whole need for access to capital as a multifaceted front. For these reasons, we got involved in such issues that I know you are familiar with, the proposed Treasury Regulation 385, which we thought would be disastrous. We have advocated cap gains rollovers over the years, industrial revenue or development bond programs, small business participating debentures, a number of equity related bills that are currently making their way through Congress. In other words, we see this as a number-one topic to assist small business in the country, and we feel that it's most important that we support any initiatives that would help to improve the investment climate and help balance the perceived risk with the rate of return that the investors see in any particular transaction.

Because of this, we do support 1666. And by way of just summarizing the last elements of my statement, I would like to say that revenue impact is of course a major concern now, but we feel this particular bill, given that it may be technically corrected in a few areas—and I would like to spend a little of my time just addressing a couple of the comments that were made earlier—we would like to see this bill go through because we feel it helps to channel productive investments into growth companies, the companies that perhaps are mature in some instances but may be embarking on production expansion and job-creating activities.

And we feel it's most important that the stimulation of these initial infusions is encouraged. The startup firm entering an explosive growth phase, or a more mature firm issuing stock to help its expansion are very pivotal times in the developments of companies, and it also in most instances, probably, is a most difficult time to raise capital. So to increase the incentive on behalf of investors in these very critical times we think is very, very important, and we feel that S. 1666 therefore would be a big contribution to the overall let's say "multifaceted" assault.

Now, I would like to just go back to a couple of the comments that were made here to show sort of like why our perspective is a little different, perhaps.

No. 1, I think that the fact of the matter is that while there are large amounts of investment going into industry these days, there are still far greater numbers, as Mr. McMurtry indicated, of proposals—and worthwhile proposals—than capital moving toward them.

This can be shown fairly easily, I think. Just this morning I talked to the National Association of SBIC's, and they indicated that, despite the fact that their investment rate is high, they still consider themselves in a demand situation; in other words, there are far more proposals than really they can fund.

The Massachusetts Technology Development Corporation in Boston, a quasi-federally funded activity, is specifically created to help lower the hurdle rate or sort of sweeten investment deals, and they are very busy because they can—just by increasing the attractiveness of an investment deal a little bit, you can attract private venture capital.

We have testified over the years on a number of these different things and, as you alluded to earlier, there are always reasons why we shouldn't do them. We complain now about the holding period being too long; yet, Treasury doesn't suggest that maybe if we hold them shorter and therefore turn things over quicker we ought to reduce the capital gains rate in that direction.

In other words, what we have found is a pattern of generally not supporting constructive proposals and trying to defeat them by coming up with technical objections. And the net result is that, other than the 1981 tax law, there has been very little done over the last 10 or 15 years to encourage investment in small and growth companies. So for that reason we applaud your initiative, sir, and we generally support the issue.

Senator **Chafee**. Well, I think the point Mr. Wellington makes is deserving of consideration, and that is that Mr. Wellington just doesn't think there is great merit in this bill as opposed to other measures. We only have so much energy around here. We always use some of it up in achieving a goal, should we press for "this goal," then our chances of having the rollover investment that Mr. Wellington referred to or even the indexation of capital gains, something like that, achieved would be greatly reduced.

So what you are in here is a situation of, what do you prefer? Where are you going to get the most for your effort? So I am greatful to each of you for your candid thoughts here. Mr. Wellington came forward and said, "Sure, this is nice, but it's just not going to do much for you." And he used the example, which I thought was a pretty good one, of somebody who had a 20-percent capital gains rate with an investment of $1,000, and investment which has earned 1,000 gain after a year; the person comes out with $800. Under this bill he would wait four more years and would come out with $900. You know, is that going to make anybody do something different?

So those are the things that we have to consider here.

Mr. **Rennie**. If I could add just one thing, Senator. I think we have to be careful not to draw conclusions from just one segment of industry or one industrial experience. The availability of new issues already is beginning to wane, and there have only been three periods where initial stock offerings in the public market have really been available to anyone since 1969.

I think that the electronics industry, and the electronics industry in California in particular, may find that there is plenty of capital around, and they have no trouble getting things. They testified very similarly in the small business innovation research bill that they didn't need any help there, either. I don't think that is typical of the country in general or industries that are growth industries but not necessarily electronics industries.

So I think, certainly, their testimony is weighty and important; but I think we have to look at a broader picture. We feel, on balance, across all industries, this has more merit than that.

Senator **Chafee**. What do you say, Mr. Wellington?

Mr. **Wellington**. Well, I hate to be in the position of a businessman arguing against motherhood, i.e., lower taxes; however, I think it reduces itself to a question of the efficiency for the overall purpose of enhancing the growth of the economy. The additional risk of several things ensuing for holding it for 4 years, for example. We all know that there is a tendency to tamper with legislation, issue new regulations, that could in fact after 3 or 4 years put that extra 10 percent into jeopardy. That's a danger when you have special treatment for certain segments of taxation. We saw that with favorable treatment of employee stock options in 1981. They were changed to reduce the benefit in 1982. A differential capital gains rate has quite a bit of risk for that sort of thing during an extensive holding period.

What we feel is a higher priority than a differentiated capital gains would be to in fact treat all capital gains the same way. But at this time, the R&D tax credit and the engineering shortage for some of the industries, and I'm talking about heavy industry also that needs the benefit of this high technology to remain competitive in the world markets, realizing that there is a shortage of the ability to offer incentives.

We all know the problem with the deficit. Given a limited choice, our feeling at this time is that the question of removing the sunset on R&D is more important, and the question of dealing with some of the education problems in the engineering and computer science field has a priority.

Senator **Chafee**. Do you think it would be fair to say, Mr. Wellington, that the AEA represents the more mature companies? Or is that an unfair statement?

Mr. **Wellington**. No. Actually, of the 2,300 companies, approximately 80 percent have less than 200 employees. We have some very large companies also.

Senator **Chafee**. And young companies?

Mr. **Wellington**. By and large. My own particular company would be classified as a medium-sized company today, in its period in the electronics company. And it's a young company. High growth is of course the reason.

Senator **Chafee**. All right, gentlemen, thank you very much for coming. We appreciate it.

Mr. **McMurtry**. Yes, sir.

Mr. **Rennie**. Thank you, sir.

[The prepared statement of John Rennie follows:]

sbu
SMALL BUSINESS UNITED
A NATIONAL NETWORK
FOR LEGISLATIVE ACTION

SBANE

Testimony
of
Mr. John C. Rennie
President, PACER Systems, Inc.
87 Second Avenue
Burlington, MA 01803
also
President, Smaller Business Association
of New England
and
President, Small Business United

September 19, 1983

before the

Senate Finance Committee
U.S. Senate

concerning
an

Ammendment to the Internal Revenue
Code of 1954 Regarding Capital
Gains Tax Rates (S.1666)

Mr. Chairman and Members of the Committee:

I appreciate very much the opportunity to testify before you today and to express support of S.1666.

My name is Jack Rennie, President of the Smaller Business Association of New England (SBANE), the oldest regional grassroots small business association in the Country with over 2000 member companies from virtually all industires. I am also testifying on behalf of Small Business United, a national coalition of state and regional small business associations encompassing 60,000 companies in three dozen states. Finally, I am President of PACER Systems, Inc., a small, growth-oriented, independent company with headquarters outside Boston. PACER manufactures aviation equipment and designs, develops and supports advanced computer-centered systems in the aviation field.

Mr. Chairman, since founding my Company in 1968, I have found that at virtually every meeting between small business owners/managers, the primary area of concern has been access to capital. These concerns have been expressed formally here on Capitol Hill for many years by SBANE, at the White House Conference on Small Business in 1980, and in the past few years by Small Business United at its annual Washington Presentation and in a number of hearings and symposia.

Access to capital...the absolute lifeblood of business, is a serious concern to all of us. I use this general term because I want to emphasize that we have been and are working hard to improve access to capital on many fronts: As examples:

- We opposed Treasury Regulation 385 because we felt it would catastrophically interfere with the relationships between the entire banking and investment community and the industrial sector;

- We have supported the Industrial Revenue or Development Bond Program because it facilitates the availability of long term debt at reasonable rates;

- We have been advocating Small Business Participating Debentures because they would be a constructive mechanism for making long term capital available to companies whose equity would not be available to, or of interest to investors; and

- We have supported the formation of a number of bills currently under consideration which would improve the climate for equity-investing in growing enterprises.

In other words, we see the entire access-to-capital issue as multi-faceted, with each element filling a particular niche in the financing of industry. The net effect of all of these proposals or provisions would be to improve the investment climate, ie. help balance the perceived risk with the rate of return so that investment funds are actually moved into companies - the productive sector of the economy - rather than languishing in non-productive repositories.

It has long been an element of enlightened public tax policy to assist the investment climate by using the tax policy, in part, to stimulate investment. By doing this, the Government can help improve the risk/return ratio to levels where investors can (and will) take a chance.

S.1666, as we see it, is such a proposal. It helps ameliorate the repressive capital gains tax policies of the 1970's (which, coupled with high interest rates, essentially eliminated the flow of long term capital to smaller firms), and broadens the possibilities of investors arriving at acceptable risk/benefit determinations, thereby stimulating investment.

There is nothing magic in this mechanism. An investor simply must be able to justify varying degrees of risk with concomitant returns. By improving the prospect of returns, S.1666 will cause more situations to be "bankable" in the eyes of investors.

Reductions in the capital gains tax in 1978 and 1981 have yielded an impressive return for their contribution to the investing climate. In 1980, only two years after the initial rate reduction, Treasury realized an $11.9 billion net increase in capital gains revenue. These changes not only improved the Government's fiscal balance, but also unlocked mature investments for access by small and medium-sized firms in need of growth capital. These are just the types of companies that provide the underpinning of the economy today, and are the major employers of the future. In a GAO survey of 1332 companies that were started with venture capital backing over the past decade, it was found that demonstrated benefits to the Nation's economy and productivity far exceeded the amounts of capital invested.

Now, we also are aware, Mr. Chairman, that revenue impact is of major concern in these times of fiscal difficulty. So we recognize that the Treasury can only use tax reduction stimulation in selected applications, else the short term cash drain would become prohibitive. That is why we favor S.1666. It specifically channels incentives toward productive investments, ie. growing companies. This is a far better use of available incentives than underwriting investments in non-productive commodities, precious stones and the like.

Even more targeted than that, S.1666 aims at stimulating funds flows to growing firms seeking what may be their initial infusion of long term capital. This critical stage involves special levels of risk, often accompanied by dynamic changes in the company's operations. Yet it is in these stages that the "start-up" firm achieves explosive growth, or the more mature firm gears up for major production programs/expansion. Thus these investments are pivotal in creating productive capacity, employment and in completing the innovation process. Since a 20% long term capital gain tax rate is available after one year of ownership, it seems reasonable that if an investor must retain the security for an additional four years - comprising perhaps the most risky period of the company's development - a tax reduction, in effect, of 2 1/2% of the capital gain per year is equitable.

We feel, therefore, that the amendment to the capital gain tax rate contained in S.1666 would have a very positive effect on the investment climate, especially in situations involving growing companies at critical phases of their development. This is a goal worth achieving...and a risk worth taking, for all of our benefits.

Thank you. I would be happy to respond to any questions the Committee may have.

John C. Rennie
President

Senator **Chafee**. All right, the next panel consists of Mr. Fisher and Mr. Cook, on S. 1550.

Go ahead, Mr. Fisher. I'm glad you are here.

STATEMENT OF LAWRENCE N. FISHER, CHAIRMAN, TAX COMMITTEE, NATIONAL CONSTRUCTORS ASSOCIATION, WASHINGTON, D.C.

Mr. **Fisher**. Thank you very much, Mr. Chairman.

My name is Larry Fisher, and I'm chairman of the National Constructors Association tax committee. As you may know, our association consists of many of the larger U.S. construction firms.

A signficant portion of our business has historically been, and hopefully in the future will continue to be, in the international market. We are very pleased today to have the opportunity to appear here in support of S. 1550, which addresses a critical problem of international double taxation which has hampered our ability to compete in many countries of the world.

We have submitted our testimony for the record prior to the hearing; however, we would ask the opportunity to file a supplemental statement within the next week to address some of the issues raised in the Treasury Department's testimony which was filed today on this bill. In this regard, we would like to point out that we were unaware of their position.

Senator **Chafee**. Sure, we would be glad to have that. How long do you think it would take you to get that in?

Mr. **Fisher**. I think a week would be more than sufficient.

Senator **Chafee**. Fine. We'll keep the record open. Why don't you get it in 10 days. We'll give you 10 days; how's that?

Mr. **Fisher**. That's excellent. Thank you.

Senator **Chafee**. Why don't you go right ahead here?

Mr. **Fisher**. While their testimony acknowledged and expressed sympathy for the problems faced by U.S. constructors, their proposed solution to this problem is, in our view, impractical and unworkable. They have suggested that the problem should be resolved through either tax treaties or unilateral changes by the foreign countries in their basic source of income rules.

Senator **Chafee**. Well, you heard Mr. Chapoton's testimony, and he was wondering if there was a problem. I think either here or in your testimony that you submit, you had better address that, with some specifics, such as where the situation has actually come up, what country, and so forth.

Mr. **Fisher**. Yes. And we have done that in various materials that have been submitted thus far.

I would like to point out, in virtually all cases these countries are developing countries, where there realistically is no prospect for the implementation of tax treaties within the foreseeable future.

With regard to the second point, on unilateral changes, the double taxation problems that we are talking about here hit U.S. trade, his U.S. jobs, and U.S. construction firms. We think it is unrealistic to think that any foreign country will be sufficiently motivated to solve this type of problem by changing its own rules of tax jurisdiction.

Senator **Chafee**. Well, didn't Mr. Chapoton in his testimony say that the rule we have is similar to that of many countries? Now, it's probably Korea, and I don't know about Italy, that is your primary competitor for overseas construction. Well, Korea, I suppose, is your big competitor. Isn't it?

Mr. **Fisher**. Yes. I think a distinction needs to be made: generally for source of services income, the general source rule are is where the services are rendered. But in this area of technical assistance, we are seeing more and more countries that are looking to where that technical assistance is used. There are a large number of countries in Latin America, in Asia, that tax technical assistance as opposed to the general services rules on this kind of basis. And I think it could be argued that this is becoming the international norm of taxation, not the general service sourcing rule.

Senator **Chafee**. Why don't you go ahead?

Mr. **Fisher**. OK. Thank you.

To get back to my comments, we think it's unrealistic to think that any foreign country will be sufficiently motivated to solve this problem by changing its own rules, and this is especially true since this is a problem that is unique to U.S. firms.

All of our major competitors, whether they have a credit system or a territorial system for avoiding double taxation, contain provisions of widely diverse types but which result in the same bottom line—elimination of the problem as far as firms of those countries are concerned.

Aside from the basic fact that the Treasury solution is not a practical one, we cannot agree with their policy reservations regarding the bill, as well. The basic concept underlying their reservation is that the United States has the right source rule and that these developing countries have the wrong source rule, and if we make this type of change then other countries will be encouraged to adopt similar "wrong" source rules.

We think that the concern about encouragement of other countries can be easily answered just by looking at the bill, since it specifically addresses this problem by providing that the deduction is not available when the Secretary determines that U.S. firms are more heavily taxed than other firms.

And just one other point on the source rule. We don't feel that there is any such thing as a "per se, correct" source rule. All source rules are arbitrary to some degree, even though based on an analysis of the economic activities giving rise to the income.

In this context, it appears that there is at least some reasonable basis for a foreign country to source this income in their country, since it relates to services that are directly incorporated into the facilities in that country. In this situation, we do not believe that the foreign source rules are clearly wrong. The Internal Revenue Code and Regulations contain many accommodations to potential conflicts in the source rules, thus there is nothing new or different about this legislative solution.

Senator **Chafee**. OK. Why don't you summarize the balance? Obviously your statement will be in the record here. Why don't you go ahead?

Mr. **Fisher**. OK.

In summary, while we, for the reasons indicated, disagree with the Treasury's policy reservations regarding the bill, we believe that the trade policy aspects of the bill—U.S. jobs, increased markets for U.S. exports, the need for greater competitiveness for U.S. companies, and also, we believe, the increase in U.S. tax revenues which will result from this bill through increased market opportunities for U.S. firms—should outweigh any technical reservations that may be posited regarding the application of the bill.

Senator CHAFEE. OK. If you could come up with examples and also meet the argument that Mr. Chapoton raised, that if the foreign countries extend their tax policy to include this, which they shouldn't do, the foreign countries, why won't they extend it to something else? And if our response is always just to permit a tax credit for it or a deduction, to respond to help the other countries, then where are we going to end up? You heard him make that argument.

Mr. FISHER. Yes, thank you.

[Mr. Fisher's prepared statement follows:]

STATEMENT OF
LAWRENCE N. FISHER
CHAIRMAN OF THE TAX COMMITTEE
NATIONAL CONSTRUCTORS ASSOCIATION

IN SUPPORT OF
S. 1550 - A BILL TO ELIMINATE INTERNATIONAL
DOUBLE TAXATION BARRIERS TO OVERSEAS
CONSTRUCTION PROJECTS FOR U.S. CONSTRUCTORS

BEFORE THE
SUBCOMMITTEE ON
SAVINGS, PENSIONS AND INVESTMENT POLICY
AND THE SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT

UNITED STATES
SENATE COMMITTEE ON FINANCE

September 19, 1983

Mr. Chairman and Members of the Subcommittees:

My name is Lawrence N. Fisher, and I am Chairman of the Tax Committee of the National Constructors Association ("NCA"). I am pleased to appear today on behalf of NCA to urge enactment of S. 1550, a bill which is of vital importance to the international competitiveness of U.S. constructors.

NCA has represented many of America's large engineering and construction companies for over 30 years. We presently have approximately 50 member companies, who are engaged in building major process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals productions and fabricating; and other major process and manufacturing needs. Our industry competes for projects both in the United States and in international markets. We provide direct employment of about 6 percent of the total U.S. work force. In addition, our industry is responsible for another 4 percent of U.S. employment through work generated by our projects for suppliers and other necessary service industries. However, the share of total worldwide construction contracts awarded to U.S. companies has dropped from about 50 percent in the mid-1970's to only about 30 percent in 1981. This discouraging trend has continued in 1982 and 1983.

S. 1550, sponsored by Senators Chafee, Symms, Grassley and McClure, addresses a very serious trade barrier of international double taxation which confronts U.S. constructors. In recent years, this problem has increasingly prevented U.S. firms from effectively competing against non-U.S. firms for international projects. Consistent with long-standing U.S. tax and trade policy, S. 1550 will remove this double tax barrier. As a result, S. 1550 will help retain and increase U.S. technical service and related jobs, increase the export of U.S. goods and supplies, and increase Federal tax revenues. The relevant facts are clear and are well-known in our industry, and S. 1550 is narrowly drawn to address the specific problem which we face.

HOW INTERNATIONAL DOUBLE TAXATION ARISES UNDER EXISTING LAW

Here is how this critical double tax situation harms U.S. constructors. If a U.S. engineering and construction firm is to perform an overseas construction project, a substantial portion of the required technical services (e.g., design, engineering, purchasing, construction management, planning, and mobilization) will need to be performed outside the construction site jurisdiction, usually in the firm's U.S. home office. As a rule of thumb, for every one hour of staff labor performed at the job site on an overseas project, there are four hours of staff labor performed outside the foreign country. Also, more than half of the total cost of the project will be for materials and equipment to be incorporated into the facility. If a U.S. firm is able to perform the project in its home office, the likelihood of U.S. material and equipment to be purchased is significantly greater. Thus, a $500 million project represents a potential export market of $250 million for U.S. suppliers and manufacturers. Overseas construction jobs thus provide a significant potential market for export of both U.S. goods and services.

An increasing number of foreign countries now impose "technical assistance taxes" on the required U.S. home office services, on the basis that the income from these services is subject to the foriegn country's taxing jurisdiction because the work is ultimately used there and paid for there.[1] The United States would also tax these services, because U.S. tax law considers the "source" of the income derived from this work to be the United States, where the technical assistance work is to be performed.

In general, under U.S. rules international double taxation on income from foreign activities is avoided by crediting against U.S. taxes the foreign taxes paid. The credit may generally only be used to offset the U.S. tax payable on foreign-source income. Because technical assistance taxes are imposed on what the United States considers to be U.S.-source income, the payment of the technical assistance tax cannot practically be used as a credit against the U.S. tax which would be due on that income.

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[1] Such countries include Argentine, Brazil, Chile, China, Colombia, Ecuador, Korea, Malaysia, Mexico, New Zealand, South Africa, Panama, Spain, Tanzania, Thailand, and Venezuela. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country.

Thus, even though technical assistance taxes qualify as creditable foreign "income taxes" under U.S. law, U.S. construction firms have no practical relief from international double taxation in many instances.

As a consequence, U.S. firms are prevented from directly competing against non-U.S. firms in these countries. Engineering and construction firms usually make less than a 10% pre-tax margin on gross billings. These foreign technical assistance taxes are usually in the range of 10%-30% of billings. Thus, a U.S. firm cannot absorb the tax, since it would be left with a substantial loss on the project.

This barrier to U.S. competition abroad is illustrated as follows:

30% Technical Assistance ("T.A.") Tax

Billings	$100	
Costs	(90)	
Pre-tax income	10	
T.A. tax	(30)	(30% of 100)
U.S. tax	(4.6)	(46% of 100)
After-tax loss	(24.6)	

Moreover, if the U.S. firm increases ("grosses-up") its contract price to cover the double tax bill, then the U.S. firm will be immediately and decisively priced out of the market. With a 30% technical assistance tax, a foreign client would have to be willing to pay $225 for every $100 worth of U.S. services for a U.S. firm to get the job. Obviously, this can never happen in real life, and the U.S. firm cannot get the work.

30% Technical Assistance Tax -
Hypothetical Gross-Up by Client Included

Billings	$100	
Hypothetical gross-up	125	
Costs	(90)	
Pre-tax income	135	
T.A. tax	(67.5)	(30% of 225)
U.S. tax	(62.1)	(46% of 135)
After-tax profit	5.4	

Thus, U.S. firms are priced out of the market in these countries. The result is a loss of U.S. jobs, a loss of U.S. exports and no Federal tax revenues paid.

THE TAX LAWS OF OUR MAJOR TRADING PARTNERS HAVE ALREADY SOLVED THIS PROBLEM

Firms from other countries, however, do not have to face this double taxation problem. The international accounting firm of Arthur Young & Company recently conducted a study of the treatment of foreign technical assistance taxes by the major trading partners of the United States. The study makes clear that the home country jurisdictions of our principal competitors provide relief from the double taxation burdens that would otherwise result from technical assistance taxes. The study concludes that existing law "places U.S. corporations at a competitive disadvantage with our major trading partners' home country corporations." (Emphasis added.)

S. 1550 adopts a mechanism consistent with our tax law principles and with the international norm established by our competitors. Thus, S. 1550 provides U.S. construction firms with a "level playing field" for international competition with foreign firms in technical assistance tax countries.

EFFECT ON U.S. TRADE AND TAX REVENUES

The only practical method presently available to U.S. firms to cope with the double taxation barrier is to render the needed technical services outside the U.S. Many of the larger U.S. firms doing business abroad have offices outside the U.S. If the technical assistance services are performed through a foreign subsidiary in one of the many countries that have solved the doubled taxation problem, then the necessity for the (practically unobtainable) double taxation gross-up may be avoided. This solution, which is now used frequently by larger firms, involves a significant revenue loss to the U.S., because primary taxing jurisdiction is shifted to the third country where the office is located. Because these countries all have relatively high tax rates that equal or exceed those of the U.S., the U.S. will lose virtually all of its potential tax revenues from the project. The home office jobs and the export market will also be lost.

Moreover, there are many small or medium size construction firms doing business abroad that do not have overseas offices and cannot economically establish them. These companies are totally foreclosed from competing in technical assistance countries.

Thus, whether the work is performed in a third country or not at all, the result is the same. The U.S. has lost the home office jobs for the project, it has lost the potential export market for equipment and materials for the project, and it has lost the U.S. tax revenues that would result from the services performed and the goods supplied in the U.S.

CONCLUSIONS

S. 1550 solves a very serious international double taxation problem in an equitable and realistic manner, consistent with U.S. tax and trade policy. It will not only raise Federal tax revenues by allowing U.S. firms to freely do the work in the U.S. on foreign projects, but will also help create and retain jobs here rather than abroad and will improve our U.S. competitiveness. It will also aid the U.S. balance of trade by encouraging an inflow of capital and the export of U.S. goods and services.

A companion bill, H.R. 1609, is sponsored in the House by Representatives Gibbons, Conable, Frenzel, Archer, Hance, Vander Jagt, Thomas and Campbell. Hearings have been held before the full Ways and Means Committee. NCA strongly urges prompt passage of this much needed legislation.

October 3, 1983

MEMORANDUM FOR THE RECORD

TO: Subcommittee on Savings, Pension and Investment Policy and Subcommittee on Taxation and Debt Management, Committee on Finance, United States Senate

FROM: National Constructors Association, by Lawrence N. Fisher, Chairman - Tax Committee

SUBJECT: S. 1550 - A Bill to Eliminate International Double Taxation Barriers to Overseas Construction Projects of U.S. Constructors

This memorandum supplements for the record the testimony presented by the National Constructors Association ("NCA") at the hearing held on September 19, 1983 in support of S. 1550.

NCA represents many of the larger U.S. engineering and construction firms. A significant portion of the business of our members has historically been in international construction markets. We are very concerned to continue our ability to compete in international markets in the future. S. 1550 would eliminate a very serious trade barrier of international double taxation which has significantly hampered our ability to compete in many foreign countries in the world. We believe S. 1550 is consistent with essential U.S. policy. Moreover, we believe S. 1550 will raise Federal revenues by substantial amounts, approximately $100 million annually. In sum, the bill is in the best interests of the United States. We urge careful consideration of S. 1550 by the Senate Finance Committee and prompt enactment by the Congress.

On September 19, 1983 the Department of the Treasury also testified concerning S. 1550. Assistant Secretary Chapoton testified that although he recognized the practical problem facing many U.S. construction companies and was sympathetic with the burden of international double taxation addressed by S. 1550, nevertheless he was not able to support the proposed remedy contained in the bill. The Treasury Department set forth a number of tax policy grounds for declining to support this measure. In this memorandum we would like to address specifically these tax policy objections. However, and most importantly, we would like to point out that the Treasury Department has failed to give consideration to the trade and jobs policy implications of the bill, and how those economic policy factors interact with tax policy considerations. The Treasury

Department has also failed to consider the increase in Federal tax revenues which we believe will result from enactment of S. 1550. We certainly disagree most strongly with Treasury's tax policy reservations. However, we believe that the Congress must carefully balance the trade policy, jobs policy, tax policy and revenue considerations. We firmly believe that a careful balancing of these different policy considerations will lead to enactment of S. 1550 at the earliest possible date.

We were most surprised by the Treasury Department's comments at the September 19, 1983 hearing to the effect that although Treasury appreciates the serious problem which foreign technical assistance taxes present for U.S. engineering and construction companies, nevertheless, "we do not have enough detailed information to assess their impact on particular contracts or on the competitive situation in particular countries." This statement, quite frankly, takes us aback. Our association, and other industry representatives, have been working closely with the Treasury Department staff and the Joint Committee staff on this measure for one year. Our first meeting with Treasury tax policy staff occurred in October 1982. A number of other meetings were held during the spring, summer and fall of 1983. The Treasury Department requested us to provide answers to a number of questions and to provide various types of information. We thoroughly and completely responded to all of these requests.

Attached for the record is a "blue book" dated June 29, 1983, which contains a detailed tax policy analysis of S. 1550; a survey by the international accounting firm of Arthur Young & Co. of relevant tax laws of United States major trading partners; a letter from the Under Secretary for International Trade of the Department of Commerce addressed to the Assistant Secretary for Tax Policy, urging Treasury Department support for the measure; a detailed economic analysis and revenue estimate for the bill; and a general and technical explanation of the bill. These materials were all made available to Treasury staff, to Congressional staff and generally to interested parties. We also attach for the record a letter dated July 22, 1983 addressed to the International Tax Counsel of the

Treasury Department providing, as requested by Treasury, an illustrative example of the competitive situations addressed by S. 1550, as well as a list of the "technical assistance tax" countries we had encountered and the applicable tax rates in those countries. This letter specifically asks whether Treasury desires any further information. Moreover, a meeting was held with Treasury staff on September 7, 1983, approximately two weeks prior to the September 19 hearing. At this meeting, we again asked whether any further information was needed.

Thus, we were very surprised by the Treasury Department's statement at the September 19 hearing that additional information was needed. We will certainly continue to work with the Treasury Department and Congressional staff to provide whatever additional facts we can. However, as we will demonstrate below, we believe that the facts are clear and are well known both in the industry and at the Treasury Department. Moreover, it appears to us that Treasury is asking for information which simply cannot be obtained by anyone, anywhere: the reason is that Treasury seems to be asking as to what the effects of this legislation will be on contracts and on competition in the future. International construction markets are highly competitive, and the market tends to be variable. There is simply no way to predict the future of the market. If the test suggested by Treasury had to be met, no tax legislation would ever be enacted.

An additional response is warranted. In discussing the anti-competitive impact of technical assistance taxes, the Treasury Department cited an example provided by our organization in which the additional tax cost to a U.S. firm was $1.4X on a job with a total installed cost of 100X (Treasury described the example as "$100 million"). The intended implication is that such a "minor" amount could not really have much of a competitive impact on the U.S. firm. Nothing could be further from the truth.

What the Treasury fails to realize, or to point out, is that the added tax of $1.4X would have put the U.S. firm in a loss position on the contract, and that if the firm had tried to increase its initial bid to cover the added cost, there would have been a significant "gross-up" factor that would make the U.S.

firm's bid for home office labor *non-competitive with non-U.S. firms*. Thus, it is the impact of the taxes on *profit margin* and *home office labor costs*, not *gross* revenues, that prevents effective U.S. competition.

Expressing the tax cost as a percentage of contract billings is very misleading. In the example cited by Treasury, 45% of the contract price was for materials and equipment. NCA's example showed that these items are always provided at cost to the client, and more often than not the purchases are made in the name of the client (usually to minimize sales taxes, customs duties, etc.), and therefore never appear as contract billings or costs of the contractor. What is relevant to competition is not the relation of the tax to *gross* receipts, but instead is the impact of the double taxation costs on the U.S. firm's *profit margin* and on the cost of U.S. labor if the double taxation costs are included in the contract price.

In the example we provided, the U.S. home office labor gross billings were 20X, consisting of:

actual costs	$15X
15% technical assistance tax	3X
estimated pre-tax profit	2X
Total	$20X

If the job had hypothetically been performed in the U.S. under existing law, the U.S. firm would have taxable income of $5X and U.S. tax of $2.3X. Thus, the additional tax cost puts the U.S. contractor in a loss position. His pre-tax profit is $2X and his U.S. tax would be $2.3X!

Obviously, no firm is going to bid for work at a loss. The competitive barrier arises if the U.S. firm tries to increase its price for U.S. labor to cover the extra tax costs. For example, including the double tax costs in the contract bid would have increased U.S. labor costs by more than 20% (i.e., the $20X contract price would hypothetically have to be increased to about $24X). In the intensely competitive international market place, clients will not pay this kind of premium for U.S. labor, particularly when non-U.S. firms do not face the double tax trade barrier. As a result, U.S. firms are effectively priced out of the market.

The international engineering and construction market is simply too competitive for U.S. firms to compete if they are subject to international double taxation. Uncertainties of cost, completion dates, supply of materials, and other factors, will cause U.S. construction firms to be non-competitive and to lose jobs and profits if the international double taxation liability is added to the project.

The Treasury Department also stated at the hearing that the impact of double taxation could be affected by other foreign transactions which the U.S. company may have undertaken. It is correct that where the taxpayer has foreign source income from other activities which have been subject to a lower foreign income tax than the U.S. income tax, the foreign tax credit may offset the technical assistance tax. However, many of NCA's members and many other U.S. engineering and construction firms are not in this fortunate tax situation. "Pure" engineering and construction firms are very unlikely to enjoy a low enough overall effective tax rate on their foreign source income so as to enable them to utilize the tax credit under existing law. This situation illustrates clearly the way that present law discriminates among similarly situated taxpayers. S. 1550 would simply restore a "level playing field" among U.S. companies and between U.S. companies and foreign firms with whom we compete.

Finally, the Treasury Department suggests that foreign governments may "waive" technical assistance taxes in contract negotiations. The possibility of this happening is extremely remote. As a general matter, special exceptions or waivers are largely a thing of the past for contractors. More specifically, as the Arthur Young & Co. study clearly demonstrates, the major U.S. trading partners (such as U.K., Japan, Canada, Netherlands) provide relief from double taxation to their national companies in this situation. Why should any foreign government which imposes a technical assistance tax waive that tax for a U.S. company, when it can instead award a contract to a company based in another country without the necessity of giving up its tax? Treasury's suggestion simply is not a practical solution to the serious problem which we face.

We would now like to address the specific tax policy objections raised by the Treasury Department. Treasury states that the U.S. rule for sourcing service income is shared by virtually all developed countries and many developing countries. This rule is that services are generally sourced where the services are performed, not where the results are used. Treasury states "we cannot reject this long-standing and widely accepted source rule." While we agree that many countries do adopt the same source rules as the U.S., that rule is by no means universal. In fact, as pointed out by the Joint Committee report on S. 1550, technical assistance taxes - which tax engineering and construction services in the country where the construction project is located rather than the country where the needed technical services are performed - are now the international norm with respect to engineering and construction projects, especially in developing countries where competition for jobs is most intense. These countries, among others, include Algeria, Argentina, Brazil, Chile, People's Republic of China, Colombia, Ecuador, Indonesia, Korea, Malaysia, Mexico, New Zealand, Panama, Spain, Tanzania, Thailand, and Venezuela.

Thus, it is simply not the case that the U.S. rule is universally recognized with respect to the taxation of our industry. It is therefore not at all clear, based on the practice of independent nations in the international community, that the U.S. rule is "correct" and that the technical assistance tax rule is "incorrect".

Thus, Treasury's reliance on the "correctness" of the existing source rule is, in our view, misplaced. Moreover, we believe there is no such thing as a per se "correct" source rule. All source rules are arbitrary to some degree, even though based on an analysis of the economic activities giving rise to the income. In this context, there is clearly a reasonable basis for the existing practice of the many foreign countries who source this type of income in their country, since it relates to services that are directly incorporated into the facilities located in their country.

The Internal Revenue Code and the regulations contain many accommodations to potential conflicts in source rules. For example, Internal Revenue Code §861(e), concerning source of income from leased aircraft vessels and space craft; Code §861(f), concerning the source of income from railroad rolling stock; reg. §1.882-5, concerning the source of interest deductions of foreign banks, and the various source rules with respect to foreign losses (for example section 904(f) and 904(c)(4) of the Code)), all contain examples of accommodations and modifications of rigid source rules which have been deemed necessary and proper by the Congress and the Treasury in order to avoid international double taxation or other problem areas. Moreover, as the Subcommittees are fully aware, in section 223 of the Economic Recovery Tax Act of 1981 Congress decided to modify (for two years) the existing Treasury source rules for U.S. research and development expenses. The Congress now has before it S. 654 which would make permanent this alteration in the source rule. In June of 1983, the Treasury released a study of this provision and recommended that the resourcing rule be extended for a two-year period. We believe it is inconsistent for the Treasury Department to support a modification of one source rule, based presumably on substantial tax and non-tax policy considerations, and yet oppose a very narrowly targeted and very necessary change in the source rule affecting the construction industry, solely on tax policy grounds without consideration of competing factors.

Treasury also objected to S. 1550 on the grounds that other countries may be encouraged to adopt "wrong" source rules, if the Congress determines to provide this necessary relief to our industry. This concern about encouraging other countries to impose these taxes can be easily answered. As pointed out by the Joint Committee, developing countries cannot increase their tax rates and their asserted tax jurisdiction without slowing the national development which they seek and desperately need. Moreover, S. 1550 addresses Treasury's objection by providing that the proposed relief is not available when the Secretary of the Treasury determines that U.S. firms are being more heavily taxed than firms from other countries. Since our major trade partners already provide the relief sought here, this anti-discrimination provision will be effective.

Treasury does offer a proposed solution to the very serious trade problem which we face. However, in our view, and with all due respect, the suggested solution is completely impractical and unworkable.

Treasury suggests that the problem should be solved through either tax treaties or unilateral changes by the foreign countries in their basic source of income rules. In virtually all cases, these countries are developing countries. As the Joint Committee notes, the United States has few treaties with developing countries, and there is no realistic prospect for implementation of treaties within the foreseeable future. While Assistant Secretary Chapoton pointed out that the U.S. now has more than 30 tax treaties with foreign countries, as far as we are aware only one of these treaties deals with technical assistance taxes. That is the treaty with Morocco, and in that case the Treasury Department, with the consent of the Senate, has ceded U.S. tax jurisdiction over Moroccan government contracts to the foreign country. The position of the Treasury in this treaty is contrary to the principle they now espouse, that the U.S. source rule is correct and must be defended as a matter of principle. We believe it is simply not realistic to contend that favorable tax treaties will be negotiated, signed and approved with foreign countries which now impose technical assistance taxes at any time in the foreseeable future.

With regard to the second point, the double taxation problem addressed by S. 1550 impacts solely on U.S. trade, U.S. jobs and U.S. construction firms. As pointed out by the Joint Committee report on S. 1550, it is long-standing U.S. tax policy that the home country (in this case, the United States) has the obligation to prevent international double taxation of income of home country taxpayers from business activity in a foreign jurisdiction. It is unrealistic to believe that any foreign country will be sufficiently motivated to solve this problem by changing its own rules of taxation. This is especially true since the problem is unique to U.S. firms. As we have pointed out, our major competitors, whether they have a credit system or a territorial system for avoiding double taxation, have provisions of widely diverse types which result in the same bottom line answer: elimination of this double taxation problem. In short, Treasury has not offered any viable solution to the very serious problem which we now face.

Finally, Treasury has not adequately addressed the revenue impacts of the bill. The Treasury is not being asked to "pick up" the cost of eliminating double taxation. As set forth in the detailed economic analysis contained in the "blue book" attached hereto, we believe that S. 1550 will raise approximately $100 million in Federal tax revenues annually. The reasons we believe these revenues will be raised are as follows: First, larger U.S. construction firms, which now attempt to avoid the double tax problem by utilizing their foreign offices to do the technical services, could retain these jobs in the U.S. Rather than pay taxes to a foreign jurisdiction and receive a U.S. foreign tax credit, these companies (and their U.S. employees) could do the work in the U.S. and pay taxes to the U.S. Treasury. Secondly, smaller U.S. firms which now cannot economically support foreign offices, would, after enactment of S. 1550, be able to bid competitively on these foreign jobs and do the work here in the U.S. Finally, by doing these projects in the U.S., U.S. engineering and construction firms could expand the potential export market for equipment and materials necessary for the jobs which they complete.

The facts are clear and, we believe, uncontested. S. 1550 is a narrowly targeted provision designed to solve a limited but very serious trade barrier. It removes an unintended and unfair aberration in the present tax system. Existing law unfairly penalizes U.S. engineering and construction firms, and effectively prevents us from competing with non-U.S. firms for overseas projects in many countries. S. 1550 solves this very serious problem of double taxation and removes this serious trade barrier in an equitable and fair way. It is consistent with U.S. tax policy and furthers important trade policy goals of our nation. It will enhance the ability of U.S. firms to compete abroad, and, as a result, will assist retention of U.S. jobs and exports of U.S. supplies and materials. It will raise U.S. tax revenues.

NCA, on behalf of its member companies, and the entire U.S. engineering and construction industry strongly support prompt enactment of this vital measure.

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July 22, 1983

Alan W. Granwell, Esquire
International Tax Counsel
United States Treasury Department
15th & Pennsylvania Avenue, N.W.
Washington, D. C. 20220

Dear Mr. Granwell:

Pursuant to your request, we enclose an illustrative example of the impact of foreign technical assistance taxes on an overseas construction project of a U.S. constructor and the applicable technical assistance tax rates in a number of countries.

We would strongly emphasize that from a tax policy standpoint H.R. 1609 (S. 1550) is carefully designed to solve a limited, but important, double taxation problem. The bill is not intended to raise the issue of whether the United States should have a different source rule for the treatment of service income as a general matter. This is a subject which goes well beyond our concerns and the terms of H.R. 1609 (S. 1550). Our bill does not deal with the tax treatment of other U.S. service providers or the tax treatment of foreign persons providing services to persons in the United States. These are all complex matters in their own right which are not addressed by this bill and are not intended to be.

Neither does the bill seek to raise issues with respect to the present foreign tax credit system. The bill assumes that the system will operate as it does under present law. The focus of the bill is purely on the particular and unique situation of U.S. construction firms seeking to compete effectively for overseas projects with companies located in home countries that allow a deduction for foreign technical assistance taxes. All of the concerns we have heard about the bill relate to matters which the bill does not deal with or affect in any respect.

We would be happy to work with you to be sure you are satisfied that the language of the bill affects only the limited situation of U.S. overseas constructors who compete overseas for their work. All of the rationale and revenue estimates that have been submitted are based upon the carefully targeted nature of H.R. 1609 (S. 1550). The need is to place American constructors in a competitive position overseas without significant international double taxation trade barriers. We do not see how this carefully delineated legislative goal can be seriously questioned, particularly since it will produce substantial economic benefits for the United States, such as increased jobs and export sales, as well as additional revenues for the Treasury.

Since the House Ways and Means Committee held a hearing yesterday on H.R. 1609, we assume that you will want to complete your report and revenue estimate promptly. For your convenience, we enclose a copy of the statement prepared by National Constructors Association for the hearing. If there is any additional help we may offer you to expedite your consideration, we will be pleased to do so.

Sincerely,

Stanford G. Ross

Stanford G. Ross

Enclosure

July 22, 1983

H.R. 1609 (S. 1550): Illustrative Example of the Impact of Foreign Technical Assistance Taxes on an Overseas Construction Project of a U.S. Constructor

The following example illustrates the impact of a foreign technical assistance ("T.A.") tax on an overseas project of a U.S. construction firm. The example is based on a real life situation; the facts have been altered to maintain confidentiality and to simplify the exposition. The example illustrates how a large U.S. firm presently attempts to avoid international double taxation by performing necessary technical services in a country which permits a deduction for the T.A. taxes.

Example

A U.S. engineering and construction firm has bid successfully on a project to construct a process plant in Country X. The bid is based on the ability to deduct the T.A. tax and is broken down as follows:

Engineering and design, procurement, project management and other technical assistance services (subject to T.A. tax)	$ 20x
Materials and supplies	$ 45x
Field construction services and labor	$ 35x
Total	$ 100x

Country X levies a T.A. tax of 15 percent of the gross income attributable to technical services needed for the project which are performed outside Country X. If the U.S. firm were to perform the technical services in the U.S., the $20x gross income would be subject to the T.A. tax and to U.S. income tax. Under existing law, no U.S. foreign tax credit would be available for the T.A. tax because the $20x is considered U.S. source income.

However, the U.S. construction firm has a foreign subsidiary operating in Country Y. Country Y grants a deduction (similar to H.R. 1609) for the T.A. tax on services performed in Country Y. Accordingly, the foreign subsidiary can perform the technical services in Country Y on a competitive basis.

The U.S. firm structures its performance of the project as follows:

1. The technical services are performed in Country Y under a contract between the client in Country X and the foreign subsidiary in Country Y. The gross payment for the services in Country Y is $20x. T.A. tax of $3x (15 percent) is withheld, and the foreign subsidiary receives $17x cash. Under Country Y tax law, the foreign subsidiary has gross income of $20x and a deduction for the T.A. of $3x. The foreign subsidiary also has deductions for its expenses in Country Y of $15x, leaving it a net profit of $2x. The foreign subsidiary pays the generally applicable income tax (50 percent) on its net profit to Country Y ($1x), distributes $1x to its U.S. parent firm, and receives a U.S. foreign tax credit of $1x. Without the deduction for T.A. taxes, the Country Y tax owed would be $2.5x (50 percent of $5x), which is more than the subsidiary's true profit of $2x.

2. The materials and supplies for the project are purchased by the foreign subsidiary in Country Y and elsewhere, either for its own account or for the account of the client, and are transferred to the client at cost. No T.A. tax is imposed.

3. The field construction work is performed within Country X by a foreign subsidiary of the U.S. firm, under a separate contract with the client. The subsidiary pays the Country X generally applicable income tax (50 percent) on its net income earned in Country X ($35x less expenses of $33x). It distributes the balance ($1x) as a dividend to the U.S. firm, which receives a U.S. foreign tax credit for the Country X income tax of $1x.

If H.R. 1609 is enacted, some or all of the technical services performed in Country Y could be performed in the U.S. by U.S. employees on a competitive basis, without the trade barrier of the T.A. tax. Full U.S. tax would be paid on such work, thereby reducing the tax paid to Country Y and the U.S. foreign credit claimed therefor.

July 22, 1983

TECHNICAL ASSISTANCE TAX COUNTRIES - APPLICABLE TAX RATES

	Technical Assistance Taxes (imposed on gross income unless otherwise noted)	Generally Applicable Income Taxes (imposed on net income unless otherwise noted)*
Argentina	18%	33%
Brazil	25%	33% (5% surtax on profits above CR 88.35 million)
Chile	20%	48.57% - local company 52.38% - branch of foreign company
Colombia	12%	40%
Ecuador	44%	44%
India	20%	45-55% - local company 70% - foreign company
Malaysia	15%	45%
Mexico	21% (formerly 42%)	graduated rates to 42%
Peoples Republic of China	10%	33%
South Africa	12.6% (42% on 30% of gross billings)	42%
Spain	15%	33%
Tanzania	20%	50% - local company 55% - foreign branch
Thailand	15% (25% on 60% of gross billings)	40%
Venezuela	5-15% (18-50% on 30% of gross billings)	18-50%

* Does not include branch remittance or dividend withholding taxes.

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Since the House Ways and Means Committee held a hearing yesterday on H.R. 1609, we assume that you will want to complete your report and revenue estimate promptly. For your convenience, we enclose a copy of the statement prepared by National Constructors Association for the hearing. If there is any additional help we may offer you to expedite your consideration, we will be pleased to do so.

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July 22, 1983

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June 29, 1983

Mr. John E. Chapoton
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, D. C. 20020

Dear Mr. Chapoton:

We understand the Treasury Department now has under consideration H.R. 1609: a bill to eliminate international double taxation barriers to overseas construction projects by U.S. contractors (sponsored by Congressmen Gibbons, Frenzel, Archer, Vander Jagt, Hance, Campbell and Thomas). This same bill was recently introduced in the Senate by Senators Chafee and Symms as S. 1550. For the reasons set out below, we believe this bill provides for an equitable and realistic solution to an important problem of double taxation and is worthy of your strong support.

We enclose for your review a survey prepared by Arthur Young & Company of the treatment of foreign technical assistance taxes by the major trading partners of the United States. For the most part, these are countries with which the United States has tax treaties and which, like the United States, provide for the allowance of a foreign tax credit. The survey makes clear that the home country jurisdictions of the principal competitors of U.S. construction firms provide relief from the double taxation burdens that would otherwise result from such host country technical assistance taxes. These jurisdictions generally permit a deduction for foreign taxes paid on domestic source technical service income (even if the taxpayer has elected to credit other foreign taxes against his income tax) or treat the technical services as foreign source income with a credit for the foreign taxes paid. Indeed, some go further and provide special incentives for companies performing this type of work. Thus, H.R. 1609 is intended only to achieve a neutral tax regime for U.S.

firms that is already available for their principal competitors. The United States would merely be removing barriers to international trade and commerce in the same manner as other major countries already have acted.

Under existing law, U.S. constructors are in many cases effectively prevented from competing with non-U.S. firms for foreign projects. This insurmountable trade barrier occurs because both the foreign country where the construction takes place and the United States may impose tax on needed technical services (e.g., engineering, design, management and planning, procurement) if the services are to be performed in the United States. This conflict in the source rules of the host country and the United States generally prevents utilization of the foreign tax credit mechanism. The result is that U.S. firms lose out on foreign projects and the United States loses revenues. (We enclose a memorandum for your review analyzing in detail the way in which the potential double taxation may result and the revenue impact of its elimination.)

If U.S. construction firms are to compete on a "level playing field" in the international arena, U.S. tax law must be changed. Host countries are entitled to exercise their primary jurisdiction to tax income emanating from economic activity in their countries. Home countries are required to institute tax mechanisms (e.g., credits, deductions or exemptions) that accommodate to host countries in the interests of permitting their nationals to conduct business abroad competitively and effectively. These international tax accommodations can at times be achieved by tax treaties. However, in the case of technical assistance taxes where there are numerous foreign countries involved with which the United States does not have, nor is likely to have in the foreseeable future, tax treaties, the United States must make the accommodation in its internal tax law if it is to be effective. Moreover, as far as we are aware, no existing tax treaty or the U.S. model tax treaty addresses this particular problem.

Mr. John E. Chapoton
June 29, 1983
Page Three

In our view, H.R. 1609 provides an equitable and realistic solution to this serious problem of double taxation. The approach it takes of allowing a deduction for foreign technical assistance taxes is entirely consistent with long-standing U.S. tax policy -- namely, to eliminate international double taxation. The bill would assist in the creation and retention of technical service and related jobs in the United States. As demonstrated in the enclosed memorandum, the bill should raise U.S. revenues, since U.S. firms could compete more effectively for foreign projects, which they are now prevented from doing.

We understand that it has been suggested that H.R. 1609 may constitute a significant policy departure, on the theory that by providing a deduction for a particular type of foreign tax, it deviates from the principle that foreign taxes are to be deducted or credited on an all-or-nothing basis. The concern appears to be that it will lead to a splitting of foreign taxes between creditable amounts and excess amounts which are deductible. The suggestion is that even if H.R. 1609 is justified, it may lead to further changes in the foreign tax credit area that are undesirable as a policy matter.

While we understand the concerns that underlie such suggestions, we believe they are misplaced in the present context. H.R. 1609 is a carefully limited solution to a very particular problem, i.e., the unintended and unfair way in which the current U.S. source rule governing services creates conflicts with foreign tax laws to produce double taxation. The bill is not really a foreign tax credit amendment, but a source rule amendment, and there is ample precedent in the tax law for modifying U.S. source rules to achieve appropriate tax results. See, e.g., Internal Revenue Code Section 861(e) (concerning source of income from leased aircraft, vessels and spacecraft); Code Section 861(f) (concerning the source of income from railroad rolling stock); Reg. section 1.882-5 (concerning the source of interest deductions of foreign banks); Section 223 of the Economic Recovery Tax Act of 1981 (concerning source of certain U.S. research and experimental expenditures); and the various source rules with respect to foreign losses (e.g., Section 904(f)) and Section 907(c)(4)). Many of the provisions of Subpart F and the DISC mechanism can be viewed as overcoming mechanical source rule concepts to achieve desired tax policy results. It is well known and generally accepted that source rules are at times inherently arbitrary and must be adapted in particular taxing contexts to reach equitable and realistic results.

The conflict in U.S. and foreign source rules in the instant situation could be addressed directly, for example, by the United States treating construction service income that relates to construction projects located abroad as foreign source income in the same manner as income (e.g., rents or royalties) from tangible personal property used in such projects. A legislative solution of this type, however, while it would be justifiable in theory, might cost substantial revenues by generating amounts of foreign source income that permit use of excess foreign tax credits. While it would be possible to limit the use of the resulting credits by a special limitation on the foreign tax credit, the resulting complexity might itself be a problem, even if the revenue losing aspects were avoided. In short, a solution based on a change in source rules is feasible, and in fact has been used by some other countries. But it is an approach that we believe would be better reserved for tax treaty negotiations since it represents a more generous accommodation by the United States than a mere deduction allowance.

The deduction mechanism of H.R. 1609 represents a minimum accommodation by the United States to the tax laws of host countries and preserves the Treasury's flexibility in treaty negotiations. Theoretically, the U.S. may be able to negotiate treaties with host countries to eliminate foreign technical assistance taxes for U.S. firms, and thereby to gain more revenue for the United States. Or the United States, in return for some quid pro quo, may decide to resource this income to the host country and allow U.S. firms a credit, as some countries do. However, the current very difficult competitive situation of U.S. construction firms simply cannot await the massive undertaking of attempting to reform and coordinate U.S. source rules with numerous countries by a tax treaty approach. H.R. 1609 resolves pragmatically the problems of a conflict in source rules and ensures the United States will not lose revenues, but can only gain revenues.

We would like to point out also that the problem at hand, and the solution proposed, is limited solely to the U.S. construction industry. Insofar as we have been able to ascertain, no other U.S. service industry is subject to the same kind or degree of double taxation. H.R. 1609 is specifically limited to construction projects and is not intended to apply to any industry other than construction. Given the unique character of the international construction industry, where there is intense competition among firms from a variety of nations, H.R. 1609 cannot serve as a precedent for others in any event.

Thus, we conclude that H.R. 1609 solves a very serious double taxation problem in an equitable and realistic manner. As the enclosed Arthur Young & Company study amply demonstrates, the bill is fully consistent with the international norms for dealing with technical assistance taxes. The Treasury should strongly support this bill as consistent with longstanding U.S. tax policy and in the best interests of the United States. It would not only raise revenues, but by unfettering U.S. construction firms, it would help create and retain jobs in the United States and generally have beneficial effects for the U.S. economy.

Sincerely,

Stanford G. Ross
Stanford G. Ross

Enclosure

ARTHUR YOUNG

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SURVEY OF TREATMENT BY EIGHT COUNTRIES OF TECHNICAL ASSISTANCE TAXES

JUNE 1983

U.S. engineering and construction firms are in many instances, now effectively prevented from competing against non-U.S. firms for foreign jobs because of international double taxation of "technical assistance" services performed in the U.S. -- e.g. engineering, procurement, construction management, etc. This is a serious trade barrier for U.S. firms. The major trading partners of the United States, on the other hand, generally provide relief from double taxation which facilitates competition by their home country corporations.

An increasing number of foreign countries tax gross payments for technical services performed outside of their country where the services relate to a construction project located within their country. Often these taxes are levied as a withholding tax on "royalties", broadly defined to include any type of technical services performed outside the country. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country. Under current United States tax law, these taxes withheld are "foreign income taxes" on United States source service income. Since the U.S. foreign tax credit is basically limited to U.S. tax on foreign source income, this conflict between the U.S. and the foreign income sourcing rules can result in double taxation of U.S. technical assistance.

The enclosed information is the result of our survey of the United States major trading partners' treatment of foreign taxes withheld on payments for engineering and design services and other technical assistance, performed within their borders by home country corporations for projects located outside their borders.

In reviewing how our major trading partners relieve double taxation of technical assistance, our inquiries focused on the following three mechanisms.

Foreign tax credits - Normally this system prevents double taxation of foreign source income of home country corporations. However, if the foreign income tax is levied on domestic source income, does the particular country adjust its foreign tax credit mechanism to avoid double taxation?

Deduction of foreign taxes - If a country taxes on a territorial basis, foreign tax credits are generally limited to those items specifically designated by a tax treaty. Often, these countries prevent double taxation of domestic source income by permitting a deduction for foreign taxes imposed on this income. Does the particular country in question permit the deduction of foreign taxes on domestic source income?

Special provisions or statutes - Does the local taxing jurisdiction have any other special provisions which would avoid the double taxation of domestic source technical service income?

We have summarized the information on the enclosed chart and narratives. Briefly stated, it appears that, although many of our trading partners relieve double taxation through a foreign tax credit system similar to the one in the U.S., they avoid the double taxation of technical assistance described above by permitting either a deduction for foreign taxes paid on domestic source income (even if the taxpayer has elected to credit other foreign taxes against his income tax) or treating technical services as foreign source income, with a credit for the foreign taxes paid. In addition, certain of our trading partners provide incentives for companies performing this type of work. This places U.S. corporations at a competitive disadvantage with our major trading partners' home country corporations.

Arthur Young & Company

June 27, 1983

TECHNICAL ASSISTANCE TAX SURVEY

	United States	Canada	France	Germany	Japan	Korea	Netherlands	Switzerland	United Kingdom
Foreign tax credit:									
Credit allowed against home country taxes for foreign taxes withheld attributable to services performed in home country	No(1)		Yes(2)			Yes		Yes(2)	Yes(2)
Deductibility of foreign taxes:									
Deduction allowed against home country income for foreign taxes withheld attributable to services performed in home country	No	Yes	Yes	Yes	Yes		Yes	Yes	Yes
Any other special provisions or statutes	No(3)				Yes	Yes			

(1) Due to mechanics of U.S. foreign tax credit limitation.

(2) Credit against home country taxes may be allowed by treaty.

(3) Except limited DISC application.

See attached summaries for captioned detailed analysis.

CANADA

Foreign tax credit:

Canada generally allows foreign tax credits only with respect to non-Canadian source income.

Deductibility of foreign taxes:

Canada allows a deduction for foreign taxes paid on Canadian source income.

Special provisions or statutes:

None.

Summary:

Canada permits the deduction for taxes withheld on Canadian source technical assistance income.

FRANCE

Foreign tax credit:

France generally does not have a foreign tax credit mechanism since it only taxes income earned within France. However, certain tax treaties provide that taxes paid to treaty countries on French source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

France allows a deduction from gross revenues for foreign taxes paid on French source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

France may by treaty permit a foreign tax credit for taxes withheld on French source technical assistance income. Otherwise, France treats the withheld tax as a reduction of taxable revenues, i.e., the equivalent of a deduction.

GERMANY

Foreign tax credit:

Germany generally allows foreign tax credits only with respect to non-German source income.

Deductibility of foreign taxes:

Germany allows a deduction for foreign taxes paid on German source income.

Special provisions or statutes:

None.

Summary:

Germany permits a deduction for taxes withheld on German source technical assistance income.

JAPAN

Foreign tax credit:

Japan generally allows foreign tax credits only with respect to non-Japanese source income.

Deductibility of foreign taxes:

Japan generally does not allow a deduction for foreign taxes paid if the taxpayer has elected to credit other foreign taxes. However, if the tax is attributable to income derived from overseas technical services (see discussion of special provisions or statutes), the foreign tax is deductible in full.

Special provisions or statutes:

Income derived from overseas transactions of technical services generate a special deduction equal to 16% of the net income. Overseas transactions of technical services includes planning, consultation, supervision, and other items related to the construction or production of plant or equipment.

Summary:

Japan permits a deduction for foreign taxes paid on Japanese source income if the income is derived from planning, consultation, supervision and other items related to the construction or production of plant or equipment.

KOREA

Foreign tax credit:

Korea treats proceeds received from overseas for engineering, design and other technical services performed in Korea by a construction company in connection with a construction project located in another country as foreign source income and any taxes withheld are entitled to foreign tax credit treatment.

Deductibility of foreign taxes:

Korea does not allow a deduction for foreign taxes.

Special provisions or statutes:

50% of the income from technical assistance performed in Korea for foreign owners are exempt from taxation for six years. This exemption does not apply to a construction company and design and engineering services performed for the construction of a building. Foreign tax credit is not allowed on income subject to this exemption.

Summary:

Korea permits a foreign tax credit for taxes withheld on Korean source technical assistance income.

NETHERLANDS

Foreign tax credit:

The Netherlands generally allow foreign tax credits only with respect to non-Netherlands source income.

Deductibility of foreign taxes:

The Netherlands allow a deduction for foreign taxes paid on Netherlands source income.

Special provisions or statutes:

None.

Summary:

The Netherlands permit a deduction for taxes withheld on Netherlands source technical assistance income.

SWITZERLAND

Foreign tax credit:

Switzerland generally allows no foreign tax credits with respect to non-Swiss source income. However, certain tax treaties provide that taxes paid to treaty countries on Swiss source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

Switzerland allows a deduction for foreign taxes paid on Swiss source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

Switzerland may by treaty permit a foreign tax credit for taxes withheld on Swiss source technical assistance income. Otherwise, Switzerland allows a deduction for taxes withheld on Swiss source technical assistance income.

UNITED KINGDOM

Foreign tax credit:

The United Kingdom generally allows foreign tax credits only with respect to non-United Kingdom source income. However, certain tax treaties provide that taxes paid to those treaty countries on United Kingdom source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

The United Kingdom allows a deduction for foreign taxes paid on United Kingdom source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

The United Kingdom may by treaty permit a foreign tax credit for taxes withheld on United Kingdom source technical assistance income. Otherwise, the United Kingdom allows a deduction for taxes withheld on United Kingdom source technical assistance income.

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

Honorable John E. Chapoton
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
15th Street & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Chapoton:

I urge Treasury Department support for H.R. 1609, a bill to allow U.S. firms the option to deduct certain taxes imposed by foreign governments on income earned from overseas engineering and construction projects. Introduced by Congressmen Gibbons and Frenzel, it prevents double taxation when these foreign taxes fall on project income generated by engineering and construction services performed in the United States. For many U.S. firms, this double taxation problem is so serious that they are unable to meet foreign competition due to tax factors. The business is either lost or supported by technical services performed outside the United States.

As the enclosed background paper and summary of H.R. 1609 explains, double taxation stems from the fact that a growing number of less developed countries treat income earned on technical services performed in the United States for a construction project located abroad as a royalty payment and withhold a "technical assistance tax" of 5 to 30 percent. Unlike income related to the sale abroad of U.S.-made products, income from services produced in the United States cannot be treated as foreign source income. The practical effect of this for the many U.S. engineering and construction companies in an excess foreign tax credit situation is that they must pay a foreign technical assistance tax on this income without the ability to either deduct or credit such taxes against U.S. tax liability.

Since nearly half the billings for most foreign construction projects are for support services performed in the United States, the resulting double taxation is a serious factor in the cost considerations that make up the bids for foreign projects. Consequently, many U.S. construction firms either refrain from bidding on foreign projects where technical assistance tax factors make them noncompetitive or use foreign subsidiaries to perform construction services where such tax considerations are present.

The main reason for changing the tax law to solve this problem for the U.S. construction industry rests on tax equity grounds -- any ordinary and necessary business expenses, including foreign taxes on U.S. source income, should be deductible to the extent they cannot be credited. In addition, the tax revenue loss would probably be negligible because of offsetting revenue gains from increased business won by U.S. firms or a larger part of contract work performed in the United States. A Treasury Department estimate on the net revenue loss of this change in our tax law could be helpful in securing enactment of H.R. 1609.

We understand that Representative Stark's Subcommittee on Select Revenue Measures will have jurisdiction over H.R. 1609 and that no hearings have as yet been scheduled. We believe it would be desirable to hold a hearing within the next few months to explore the scope of the problem and appropriate relief measures, including H.R. 1609. My staff would be pleased to discuss with Treasury officials in greater detail our views on the problem created by current tax law and the H.R. 1609 remedy.

Sincerely,

Lionel H. Olmer/CW

Lionel H. Olmer

BACKGROUND AND SUMMARY
of H.R. 1609
Introduced by Representatives Gibbons and Frenzel
February 23, 1983

Background:

Many U.S. engineering and construction companies earn income from foreign construction projects for services performed in the United States. A growing number of less-developed countries tax the amount paid to the U.S. company for such services as if it were a royalty. The rate for this "technical assistance tax" (TAT) varies from 5 to 30 percent. Countries collecting a TAT include Algeria, Argentina, Brazil, Chile, Colombia, Ecuador, Indonesia, Korea, Malaysia, Mexico, South Africa, Spain, Tanzania, Thailand, and Venezuela. For the U.S. engineering and construction companies, paying the tax is a necessary business expense.

Since the United States taxes the worldwide income of U.S. businesses, it also taxes the income arising from the construction services. The TAT would ordinarily qualify for the foreign tax credit, as it is an income tax paid to a foreign government. However, many U.S. companies cannot use the foreign tax credit to offset U.S. tax liability, because section 904 of the Internal Revenue Code limits the amount of foreign tax credit the taxpayer can claim to offset income taxes paid to a foreign country.

The limitation is based on the amount of the taxpayer's worldwide income considered "foreign source income" determined under section 861. Although income from U.S. input to products which are eventually exported will often qualify as foreign source income, income from U.S. input to services, even when sold to foreign buyers for consumption abroad, is deemed to be U.S. source income. Consequently, an engineering and construction company exporting U.S.-produced services cannot count income from these sales as foreign source income. The result is to lower the limit on foreign tax credits under section 904. In practice, many companies find they have insufficient credits to offset on their U.S. returns the full amount of income taxes they have paid to foreign governments. These companies are considered to be in an excess foreign tax credit situation.

U.S. engineering and construction companies are frequently in an excess foreign tax credit situation. The TAT, a foreign tax on U.S. source income, contributes nothing to raise the foreign tax credit limitation, so the companies cannot credit it.

Nor can the companies deduct expenses of the TAT, because section 275 of the Internal Revenue Code requires companies to elect either to credit foreign income taxes or to deduct them. The election to credit applies to all foreign income taxes paid, and bars any deduction. Conversely, the election to deduct bars a credit of foreign income taxes. Most taxpayers, including U.S. engineering and construction companies, elect the credit, because it is ordinarily twice as beneficial as the deduction. Consequently, once these engineering and construction companies make the election to credit all foreign income taxes, they cannot deduct the TAT.

The result is that the income from construction contract services is subject to double taxation. Because nearly half the billings for a foreign project are for construction contract services performed in the United States and subject to the TAT, the loss of income resulting from double taxation is serious enough to make many engineering and construction companies uncompetitive in international markets.

One potential solution would be to compel the foreign customer to pay the TAT for the U.S. company. The following example shows why this solution is unsatisfactory. For a $1 billing, and a 20 percent TAT, the U.S. company would need to bill an additional 25¢, for a total of $1.25. If the foreign customer agrees to pay the additional 25¢, then U.S. tax law considers that the U.S. company's taxable income is increased by 25¢. If the foreign customer pays U.S. tax on the 25¢, then this payment is also taxable. The total cost to the foreign customer paying tax on the successive roll-overs is too high. A U.S. company insisting on this solution will be uncompetitive.

H.R. 1609, introduced by Representatives Gibbons and Frenzel on February 23, 1983, would help alleviate this problem for U.S. engineering and construction companies.

Summary of H.R. 1609:

Sections 1(a) and 1(b) of H.R. 1609 amends section 275 of the Internal Revenue Code by adding a new subsection (b). Subsection a(4) of section 275 now provides that a taxpayer electing to credit foreign taxes under section 901 can deduct no foreign taxes. Subsection (b) would make an exception to this rule. It would allow a taxpayer to "elect to deduct" on a U.S. tax return foreign "income, war profits, and excess profits taxes," such as the technical assistance tax, imposed on construction contract services performed in the United States, but which relate directly to foreign construction projects, even though the taxpayer credits other foreign taxes on foreign source income.

Subsection (b) also defines "construction contract services" very broadly, including "engineering, architectural, design project management, procurement, cost estimating, scheduling, construction planning or construction mobilization," and some other services related to any of the foregoing services.

Finally, subsection (b) would authorize the Secretary of the Treasury to disallow the deduction if U.S. companies pay a higher tax on construction contract services than taxpayers of other countries. This provision is intended to insure that the U.S. Treasury does not absorb the cost of a discriminatory foreign tax.

A new subsection (h) of section 901 would prohibit a company electing to deduct the TAT from claiming a credit as well.

U.S. Department of Commerce
International Trade Administration
May 10, 1983

June 29, 1983

Analysis of H.R. 1609 (S. 1550): A Bill To Eliminate International Double Taxation Barriers to Overseas Construction Projects of U.S. Constructors

Existing law prevents U.S. engineering and construction firms from bidding successfully against non-U.S. firms on certain overseas projects. This unfair situation occurs where foreign countries impose "technical assistance taxes" on the U.S. construction services (*e.g.*, engineering, construction management, procurement of materials) which would be needed for the foreign project but which would be performed in the U.S. Such services would also be taxed in the U.S., leading to the possibility of international double taxation. No foreign client will agree to pay a contract price that reflects the huge double tax bill which would be owed to the foreign country and to the U.S. (See illustrations below.) Nor can the U.S. company absorb the double tax. In situations of this kind, international double taxation creates an insurmountable trade barrier which prevents U.S.-based operations from obtaining the foreign work.

An increasing number of foreign countries now tax income from services performed outside of that country, if the services relate to a construction project located within that same country. Such countries include Algeria, Argentina, Brazil, Chile, China, Colombia, Ecuador, Indonesia, India, Korea, Malaysia, Mexico, New Zealand, South Africa, Panama, Spain, Tanzania, Thailand, and Venezuela. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country.

H.R. 1609 (S. 1550 is the identical Senate bill) remedies this serious problem in an equitable manner that will generate U.S. economic activities and increase the flow of funds into the U.S. The bill allows a deduction for "technical assistance taxes" as a cost of doing business, thus eliminating the double taxation barrier. By permitting U.S. firms to obtain the foreign work and earn the taxable income, which they now cannot do, the bill will raise Federal revenues.

The revenue gain to the U.S. Treasury from enactment of H.R. 1609 is estimated at $100 million or more annually. In the double taxation situations affected by H.R. 1609, a U.S. company at present cannot obtain the overseas construction project, and therefore the United States is now receiving no U.S. tax revenues. On the other hand, if H.R. 1609 is enacted the U.S. will gain revenues, since U.S. companies will be able to bid on and perform overseas projects which involve technical services performed in the U.S., and they will pay full U.S. taxes on the U.S. income from such projects. This U.S. taxable activity and the resultant revenue gain would not take place but for the enactment of H.R. 1609.

Background: How U.S. Firms Currently Deal With The Double Taxation Problem

The problem addressed by H.R. 1609 has only arisen in recent years as foreign countries have increasingly adopted technical assistance taxes that are regarded as creditable foreign income taxes under U.S. law.

U.S. engineering and construction firms usually make less than a 10% pre-tax margin on gross billings. Foreign technical assistance taxes are usually in the range of 10-30% of billings. Thus, a U.S. firm cannot absorb the tax, the project cannot be undertaken and no U.S. taxes are paid. This barrier to U.S. competition abroad is illustrated as follows:

30% Technical Assistance Tax

Billings	$100	
Costs	(90)	
Pre-tax income	10	
T.A. tax	(30)	(30% of 100)
U.S. tax	(4.6)	(46% of 10)
Post-tax loss	(24.6)	

While these figures suggest apparent U.S. tax revenues of 4.6%, this situation cannot exist in real life: no firm will undertake work which must inevitably produce a net loss of 24.6%.

Moreover, if the U.S. firm seeks to have the foreign client pay the tax, in the form of a double taxation "gross-up," the U.S. firm will be immediately priced out of the market.

30% Technical Assistance Tax -
Hypothetical Gross-Up by Client Included

Billings	$100	
Hypothetical gross-up	125	
Costs	(90)	
Pre-tax income	135	
T.A. tax	(67.5)	(30% of 225)
U.S. tax	(62.1)	(46% of 135)
Post-tax profit	5.4	

Again, the apparent U.S. tax of 62.1% cannot exist in real life, since no client is willing to pay a gross-up that increases the cost of the project by 125%.

What happens at present in the real world is that the U.S. firm interested in a project seeks to find a way to do business without asking the client for the (unattainable) huge gross-up. The possible ways of doing this are as follows:

1. Local Tax Exemption - In some countries it may be possible to obtain an exemption. These exemptions normally are granted only to important development projects in favored industries. However, exemptions of this type are becoming very rare. Moreover, H.R. 1609 would not apply to situations in which an exemption is available, since no technical assistance tax would be paid. H.R. 1609 would provide no tax benefit in these cases.

2. Foreign Government Subsidy - Where the client is a foreign governmental entity it may be possible to determine that the tax payment is subsidized by the government and that no "tax" has been paid. Again, H.R. 1609 would not apply and would provide no benefit. The payment to the government would in effect be deducted under existing U.S. law.

3. Move U.S. Services Offshore - Most U.S. firms doing business abroad have offices outside the U.S. If the technical assistance services are performed through a foreign subsidiary in a country that has solved the double taxation problem (e.g., Canada, U.K., the Netherlands), then the necessity for a gross-up is avoided. This solution, which is now used frequently, involves a significant revenue loss to the U.S., because primary taxing jurisdiction is shifted to the country where the office is located. H.R. 1609 would permit U.S. firms to avoid this solution, thereby raising U.S. revenues.

In summary, U.S. firms attempt to cope with the double taxation situation in various ways. However, they cannot always be successful, and they are inevitably handicapped by their inability to proceed straight-forwardly to secure the contracts. Most importantly, the only currently available method of general application -- moving the U.S. services offshore -- results in a loss of tax revenue to the U.S.

In contrast, our major trading partners which have tax systems similar to ours (e.g., Canada, U.K., the Netherlands) permit a deduction, similar to H.R. 1609, for foreign taxes imposed on construction services performed in the home country. If American firms are to compete effectively in the international marketplace, U.S. law must provide similar relief from double taxation on an equal and fair basis.

Why No U.S. Revenue Loss Results From H.R. 1609

Any theory that H.R. 1609 involves a revenue expenditure would have to be based on the erroneous assumption that affected U.S. firms are now doing business in countries that impose technical assistance taxes and are providing the home office services for these projects in the U.S., despite the double tax burden. Statistical surveys show U.S. firms doing significant work in countries with technical assistance taxes. But these are not situations in which both U.S. and foreign taxes are presently being paid on U.S. services and which would be affected by H.R. 1609.

H.R. 1609 can produce a revenue loss *only if* U.S. taxes are currently being paid in the situations which H.R. 1609 would affect. Where a technical assistance tax that would produce double taxation is involved, there is every incentive not to do the work in the U.S. As indicated above, the most effective method of avoiding double taxation is by providing the home office services offshore through a foreign subsidiary. Thus, the undisputed fact is that the U.S. Treasury is now collecting *no* taxes in these cases. What H.R. 1609 does is allow the U.S. to realize tax revenues that it now does not receive. The actual effect of H.R. 1609 is illustrated as follows:

No T.A. Tax	
Billings	$100
Costs	(90)
Pre-tax profit	10
U.S. tax	4.6
Net profit	5.4

30% T.A. Tax with H.R. 1609	
Billings	$100
Foreign tax gross-up	43
Costs	(90)
H.R. 1609 deduction	(43)
Pre-tax profit	10
U.S. tax	4.6
Net profit	5.4

Under H.R. 1609, the U.S. firm can do the overseas work and pay the full amount of U.S. taxes which should be paid. *U.S. tax revenues will be gained, not lost.*

How H.R. 1609 Will Raise U.S. Revenues

H.R. 1609 will increase U.S. taxable activity in generally two ways: (1) Technical services and related economic activity (*e.g.*, procurement of materials) which are now carried on through foreign subsidiaries in order to minimize international double taxation could be moved into the U.S. and made subject to U.S. tax; and (2) U.S. firms could more effectively bid through their U.S. offices for additional overseas construction projects, and the necessary technical services for such projects would be performed in the U.S. Each of these two components to the U.S. revenue gain must be evaluated independently.

(1) *Work moved to U.S. from foreign subsidiaries*. This component of the revenue gain is based on current levels of overseas contract activity, a portion of which could be moved to the U.S. after enactment of H.R. 1609.

The total value of foreign construction awards to foreign affiliated companies of U.S. construction firms in the full year following enactment can be conservatively estimated at $50 billion, based on the fact that total awards in 1981 were $48.8 billion (Engineering News Record, April 22, 1982).

The next step is to estimate the amount of awards that will be in countries imposing technical assistance taxes. While an exact projection is not possible, since foreign tax laws are continually in the process of change, the growing number of these taxes makes reasonable an estimate of about 25%, or $12.5 billion.

Of the latter amount, it can be estimated based on experience that roughly 20%, or $2.5 billion, involves technical assistance services and related economic activities (e.g., procurement of materials) which can be performed outside the host country, either in the U.S. or in a foreign country where the U.S.-based firm has a subsidiary.

Next, it is estimated that about 50% of the latter contract activity, performed outside the host country, is now performed in the U.S. in all events. This activity involves U.S. companies which are able to take a foreign tax credit for the technical assistance taxes paid. These companies are often members of U.S. consolidated groups which include non-construction businesses which generate low-taxed foreign source income, thereby allowing utilization of the foreign taxes imposed on the U.S. construction services. It is important to understand that since a credit against tax is always more valuable than a deduction, these companies would not elect the deduction permitted by H.R. 1609 and there would be no revenue impact from the bill with respect to their activities.

However, in order to avoid double taxation, the other 50% of existing projects are now performed through foreign affiliated companies of U.S. construction firms. Under existing law, the projects attributable to these affiliated companies are now not taxed by the U.S. This 50% represents about $1.25 billion of gross revenues now lost to the U.S.

The profit margin on these U.S. revenues can be estimated at about 10%, which would produce $125 million of taxable income. Thus, if the law is changed to allow this work to be done in the U.S., the U.S. revenue gain is 46% of $125 million, or about $57.5 million.

(2) Additional projects successfully bid by U.S. firms. Further, if H.R. 1609 is enacted, it is reasonable to expect that U.S. companies can obtain additional overseas construction awards, which they cannot obtain through foreign subsidiaries, as a result of being able to freely perform the work directly through their main U.S. offices. U.S. home office facilities and employees are generally more efficient and productive than foreign subsidiary offices. As a consequence, the amount of home office services performed in the U.S. would be further increased. Thus, it is likely that the total U.S. revenue gain would exceed the $57.5 million estimated for the first component. If awards increase by only as little as $5 to $10 billion, U.S. gross revenues would increase by $1 to $2 billion (20%), U.S. profits by $100 to $200 million (10%), and U.S. tax revenues by about $46 to $92 million (46%).

Summary of U.S. Revenue Gain

The estimates made above can be summarized as follows:

1.	Total annual value of foreign construction awards to foreign affiliates of U.S. companies	$ 50 billion
2.	Portion of (1) attributable to countries that impose technical assistance tax (25%)	$ 12.5 billion
3.	Portion of (2) to be performed outside the host country (20%)	$ 2.5 billion
4.	Portion of (3) which could be moved to U.S. (50%)	$ 1.25 billion
5.	U.S. profit margin on (4) (10%)	$ 125 million
6.	Annual revenue gain on existing levels of awards (46% of (5))	$ 57.5 million
7.	Annual revenue gain from increased awards	$ 46 million or more
8.	Total annual U.S. revenue gain	$ 100 million or more

The foregoing estimates relate solely to the increase in corporate taxes to be paid directly by the U.S. firms performing technical services. Additional revenue gains would be derived from taxes imposed on the employees of the U.S. construction firms and on the U.S. vendors of construction materials and equipment and on the employees of these U.S. vendors. Absent H.R. 1609, these taxes are now being paid to foreign governments, not to the U.S. Treasury.

CONCLUSIONS

H.R. 1609 is an equitable and proper way to solve this serious problem, consistent with long-standing U.S. tax policy, and to remove this unfair trade barrier to effective U.S. competition abroad. Under the bill, U.S. companies will pay the full and proper amount of U.S. taxes on the work they do. H.R. 1609 is clearly in the economic interests of the U.S.: it will aid U.S. jobs and the U.S. balance of trade, and will increase U.S. tax revenues.

STATEMENT OF PATRICK R. COOK, CHAIRMAN, INTERNATIONAL TAX COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, WASHINGTON, D.C.

Senator **Chafee**. Good afternoon, won't you proceed Mr. Cook?

Mr. **Cook**. Thank you, Mr. Chairman.

My name is Patrick Cook, and I am vice president of finance of Blount International. I am testifying today for the Associated General Contractors of America.

AGC members perform 50 percent of the contract construction performed by American firms abroad.

I am pleased to be able to testify today in support of Senate bill 1550. U.S. contractors are now being confronted with a growing number of countries which impose technical assistance taxes on payments for services related to foreign construction projects. S. 1550 would place American contractors in the same position regarding technical assistance taxes as our international competitors by allowing them to be deducted as a cost of doing business in the United States.

Without legislative relief, small American firms are prevented from competing in these countries, and larger firms are forced to alter their business practices. For example, my firm recently opened an office in Malaysia. Malaysia imposes a technical assistance tax of 15 percent on payments for construction-related services for contracts which our home office staff would normally perform. Because of technical assistance taxes, we can no longer compete on construction-related services, and our bidding activities are limited to incountry construction activities in Malaysia.

These taxes are commonly found in Latin America and Asian nations. And as you know, Mr. Chairman, the U.S. tax rules are most restrictive in dealing with these taxes. The U.S. treatment of these taxes results in international double taxation on the service payments, and creates a significant trade barrier which reduces U.S. Treasury revenue by preventing firms from being competitive and forcing U.S. firms to implement alternative business methods such as offshore operations. Operating offshore is an alternative for only those firms who have a sufficient volume of work to sustain their operations. As a result, many U.S. firms attempting to enter the market are more severely impacted, because it becomes more difficult for them to implement alternative methods of dealing with the taxes and doing business in these countries.

The solution for dealing with this international double taxation problem provided in S. 1550 is consent with U.S. international tax policy and the general treatment accorded these taxes in countries with systems similar to the United States.

International engineering construction industries have the potential to be a catalyst for increased export trade. Our contribution to the U.S. position in world trade, therefore, goes far beyond the primary impact of initial contracts for construction and construction-related services.

An endless array of Government support, both visible and invisible, is provided by foreign governments to their country's firms. To cope with this foreign support, it is urgent that the U.S. Government remove our own barriers and disincentives. Enacting S. 1550 into law would remove one significant barrier, and we encourage you to do so.

Thank you, Mr. Chairman.

[The prepared statement of Patrick Cook follows:]

Testimony of
Patrick Cook
Presented to
Finance Subcommittees on Savings,
Pensions and Investment Policy and
Taxation and Debt Management
United States Senate
on the Topic of
Foreign Technical Assistance Taxes
September 19, 1983

AGC is:

- More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
- 112 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities;
- Over $100 billion of construction annually.

Good afternoon, my name is Patrick Cook and I am the Vice President of Finance of Blount International, Ltd., an international construction company based in Montgomery, Alabama. I am testifying today for the Associated General Contractors of America as chairman of the Association's International Tax Subcommittee. AGC members perform 80% of the contract construction performed in the United States and 50% of the contract construction performed by American firms abroad. AGC members are responsible for the employment of 3,400,000 individuals as a result of these construction activities.

I am pleased to be able to testify today in support of S. 1550. U. S. contractors are now being confronted with a growing number of countries which impose technical assistance taxes on payments for services related to a foreign construction project. These technical assistance taxes are imposed when construction related services are not performed in the country where the project site is located. The services include construction planning and mobilization, design, engineering, procurement, and project management. S. 1550 would place American contractors in the same position regarding these technical assistance taxes as our international competitors by allowing them to be deducted as a cost of doing business in the U.S. Without legislative relief smaller American firms are prevented from competing in these countries and larger firms, with sustained international operations, are forced to alter their business practices and lower their effectiveness in competing.

For example, my firm recently opened an office in Malaysia. Malaysia imposes a technical assistance tax of 15 percent on payments for construction related services for contracts which our home office staff would normally perform. Because of the technical assistance taxes, we can no longer compete on construction related services, and our bidding activities are limited to "in country" construction activities in Malaysia. Other firms, usually from other countries, take separate contracts for the construction related services.

Technical assistance taxes generally take the form of a withholding or royalty tax which is collected and turned over to the taxing jurisdiction by the owner of the project. These taxes are commonly found in Latin American and Asia nations. A survey of the treatment of the taxes by Arthur Young and Co. (attached) shows that the U.S. tax rules are the most restrictive in dealing with these taxes. Payments for construction related services are subject to U.S. tax, however, the U.S. system generally does not take into account the taxes paid to the country on the technical services being provided. Under present law a U.S. taxpayer is required to deduct or credit all foreign income taxes, subject to certain limitations. Most firms elect the foreign tax credit rather than deducting foreign taxes. The foreign tax credit does not apply to "U.S. source" income, and since the services are performed in the U.S., resulting income is U.S. source and consequently the technical assistance taxes are not creditable. The U.S. treatment of these taxes results in an international double taxation on the service payments and creates a significant trade barrier which reduces U.S. Treasury revenue by preventing firms from being competitive and forcing U.S. firms to implement alternative business methods such as off-shore operations.

Operating off shore is an alternative only for firms who have a sufficient volume of work to sustain operations. Another alternative method is to send personnel to the country in which the project is located to perform the services. This is often more expensive and the employees may not be subject to U.S. taxes, thereby further reducing U.S. tax revenues. These methods of dealing with the technical assistance taxes are awkward and expensive. As a result, many U. S. firms are precluded from competing. Smaller international contracting firms and firms attempting to enter the market are more severely impacted because it is more difficult for them to implement the alternative methods of dealing with the tax. All U.S. firms are disadvantaged because they must substitute alternative business practices for the most economic method of doing business, which is to perform these services in the U.S.

The solution for dealing with this international double taxation problem provided in S. 1550 is consistent with U.S. international tax policy and the general treatment accorded these taxes in countries with systems similar to the U.S. Our principal competitors in the international construction market are generally allowed a deduction for foreign technical assistance taxes when those services are performed in their home countries and the resulting income is classified as domestic source income. A credit is provided for taxes paid on foreign source income. S. 1550 provides this treatment for American firms and will eliminate the present bias in the U. S. system by providing a tax neutral treatment of these taxes. U.S. firms which are now forced to perform these services abroad will be able to relocate their operations in the U.S.

In analyzing the effects of S. 1550 it must be remembered that the international engineering-construction industries have the potential to be a catalyst for increased export trade. As the designers, planners and constructors of multi-billion dollar projects, we can provide foreign markets for U.S. manufactured materials, installed machinery and a continuing market for spare parts. Our contribution to the U.S. position in world trade, therefore, goes beyond the primary impact of initial contracts for construction and related services.

The top 400 firms in the industry in recent years have secured 30% of their total work from overseas projects. These international awards alone translated into revenues of $53.6 billion in 1981. While construction in the United States has declined an average of 3.4% per year since 1973 in real terms, construction in foreign markets has expaned. This growth largely reflects the impact of OPEC surpluses from two oil price hikes which increased overseas construction opportunities. For example, according to U.N. statistics, construction spending in the Asia-Middle East regions increased at real annual rata of 12% following the 1973/74 price hike.

Despite the growth of U.S. activity in international construction markets during the last ten years, our share of international awards has taken a dramatic decline -- from over 50% in the mid seventies, to less than 30% in 1981. Our revenues from international awards, in fact, dropped 16% in 1982.

American firms in our industry who venture abroad and succeed in penetrating foreign markets do so because of advanced technology and perserverance. An endless array of government support, both visible and invisible, is provided by foreign governments to their countries' firms. To cope with this foreign support it is urgent that the U.S. Government remove our own barriers and disincentives. Enacting S. 1550 into law would remove one significant barrier and we encourage you to do so.

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SURVEY OF TREATMENT BY EIGHT COUNTRIES OF TECHNICAL ASSISTANCE TAXES

JUNE 1983

U.S. engineering and construction firms are in many instances, now effectively prevented from competing against non-U.S. firms for foreign jobs because of international double taxation of "technical assistance" services performed in the U.S. -- e.g. engineering, procurement, construction management, etc. This is a serious trade barrier for U.S. firms. The major trading partners of the United States, on the other hand, generally provide relief from double taxation which facilitates competition by their home country corporations.

An increasing number of foreign countries tax gross payments for technical services performed outside of their country where the services relate to a construction project located within their country. Often these taxes are levied as a withholding tax on "royalties", broadly defined to include any type of technical services performed outside the country. These foreign taxes are usually imposed by requiring the owner of the project to withhold the tax on all payments for services performed outside the country. Under current United States tax law, these taxes withheld are "foreign income taxes" on United States source service income. Since the U.S. foreign tax credit is basically limited to U.S. tax on foreign source income, this conflict between the U.S. and the foreign income sourcing rules can result in double taxation of U.S. technical assistance.

The enclosed information is the result of our survey of the United States major trading partners' treatment of foreign taxes withheld on payments for engineering and design services and other technical assistance, performed within their borders by home country corporations for projects located outside their borders.

In reviewing how our major trading partners relieve double taxation of technical assistance, our inquiries focused on the following three mechanisms.

Foreign tax credits - Normally this system prevents double taxation of foreign source income of home country corporations. However, if the foreign income tax is levied on domestic source income, does the particular country adjust its foreign tax credit mechanism to avoid double taxation?

Deduction of foreign taxes - If a country taxes on a territorial basis, foreign tax credits are generally limited to those items specifically designated by a tax treaty. Often, these countries prevent double taxation of domestic source income by permitting a deduction for foreign taxes imposed on this income. Does the particular country in question permit the deduction of foreign taxes on domestic source income?

Special provisions or statutes - Does the local taxing jurisdiction have any other special provisions which would avoid the double taxation of domestic source technical service income?

We have summarized the information on the enclosed chart and narratives. Briefly stated, it appears that, although many of our trading partners relieve double taxation through a foreign tax credit system similar to the one in the U.S., they avoid the double taxation of technical assistance described above by permitting either a deduction for foreign taxes paid on domestic source income (even if the taxpayer has elected to credit other foreign taxes against his income tax) or treating technical services as foreign source income, with a credit for the foreign taxes paid. In addition, certain of our trading partners provide incentives for companies performing this type of work. This places U.S. corporations at a competitive disadvantage with our major trading partners' home country corporations.

Arthur Young & Company

June 27, 1983

TECHNICAL ASSISTANCE TAX SURVEY

	United States	Canada	France	Germany	Japan	Korea	Netherlands	Switzerland	United Kingdom
Foreign tax credit:									
Credit allowed against home country taxes for foreign taxes withheld attributable to services performed in home country	No(1)		Yes(2)			Yes		Yes(2)	Yes(2)
Deductibility of foreign taxes:									
Deduction allowed against home country income for foreign taxes withheld attributable to services performed in home country	No	Yes	Yes	Yes	Yes		Yes	Yes	Yes
Any other special provisions or statutes	No(3)				Yes	Yes			

(1) Due to mechanics of U.S. foreign tax credit limitation.

(2) Credit against home country taxes may be allowed by treaty.

(3) Except limited DISC application.

See attached summaries for captioned detailed analysis.

CANADA

Foreign tax credit:

Canada generally allows foreign tax credits only with respect to non-Canadian source income.

Deductibility of foreign taxes:

Canada allows a deduction for foreign taxes paid on Canadian source income.

Special provisions or statutes:

None.

Summary:

Canada permits the deduction for taxes withheld on Canadian source technical assistance income.

FRANCE

Foreign tax credit:

France generally does not have a foreign tax credit mechanism since it only taxes income earned within France. However, certain tax treaties provide that taxes paid to treaty countries on French source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

France allows a deduction from gross revenues for foreign taxes paid on French source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

France may by treaty permit a foreign tax credit for taxes withheld on French source technical assistance income. Otherwise, France treats the withheld tax as a reduction of taxable revenues, i.e., the equivalent of a deduction.

GERMANY

Foreign tax credit:

Germany generally allows foreign tax credits only with respect to non-German source income.

Deductibility of foreign taxes:

Germany allows a deduction for foreign taxes paid on German source income.

Special provisions or statutes:

None.

Summary:

Germany permits a deduction for taxes withheld on German source technical assistance income.

JAPAN

Foreign tax credit:

Japan generally allows foreign tax credits only with respect to non-Japanese source income.

Deductibility of foreign taxes:

Japan generally does not allow a deduction for foreign taxes paid if the taxpayer has elected to credit other foreign taxes. However, if the tax is attributable to income derived from overseas technical services (see discussion of special provisions or statutes), the foreign tax is deductible in full.

Special provisions or statutes:

Income derived from overseas transactions of technical services generate a special deduction equal to 16% of the net income. Overseas transactions of technical services includes planning, consultation, supervision, and other items related to the construction or production of plant or equipment.

Summary:

Japan permits a deduction for foreign taxes paid on Japanese source income if the income is derived from planning, consultation, supervision and other items related to the construction or production of plant or equipment.

KOREA

Foreign tax credit:

Korea treats proceeds received from overseas for engineering, design and other technical services performed in Korea by a construction company in connection with a construction project located in another country as foreign source income and any taxes withheld are entitled to foreign tax credit treatment.

Deductibility of foreign taxes:

Korea does not allow a deduction for foreign taxes.

Special provisions or statutes:

50% of the income from technical assistance performed in Korea for foreign owners are exempt from taxation for six years. This exemption does not apply to a construction company and design and engineering services performed for the construction of a building. Foreign tax credit is not allowed on income subject to this exemption.

Summary:

Korea permits a foreign tax credit for taxes withheld on Korean source technical assistance income.

NETHERLANDS

Foreign tax credit:

The Netherlands generally allow foreign tax credits only with respect to non-Netherlands source income.

Deductibility of foreign taxes:

The Netherlands allow a deduction for foreign taxes paid on Netherlands source income.

Special provisions or statutes:

None.

Summary:

The Netherlands permit a deduction for taxes withheld on Netherlands source technical assistance income.

SWITZERLAND

Foreign tax credit:

Switzerland generally allows no foreign tax credits with respect to non-Swiss source income. However, certain tax treaties provide that taxes paid to treaty countries on Swiss source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

Switzerland allows a deduction for foreign taxes paid on Swiss source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

Switzerland may by treaty permit a foreign tax credit for taxes withheld on Swiss source technical assistance income. Otherwise, Switzerland allows a deduction for taxes withheld on Swiss source technical assistance income.

UNITED KINGDOM

Foreign tax credit:

The United Kingdom generally allows foreign tax credits only with respect to non-United Kingdom source income. However, certain tax treaties provide that taxes paid to those treaty countries on United Kingdom source income will be allowed as foreign tax credits.

Deductibility of foreign taxes:

The United Kingdom allows a deduction for foreign taxes paid on United Kingdom source income if no credit is permitted under the previously discussed principle.

Special provisions or statutes:

None.

Summary:

The United Kingdom may by treaty permit a foreign tax credit for taxes withheld on United Kingdom source technical assistance income. Otherwise, the United Kingdom allows a deduction for taxes withheld on United Kingdom source technical assistance income.

Senator **Chafee**. Well, thank you very much, Mr. Cook.

Did 911 changes help you?

Mr. **Cook**. Well, I think yes, but in a different way. All we are asking for here is that we have a chance here.

Senator **Chafee**. That's a different subject, I know. I was just curious.

Who is your principal competition overseas? What nation—Korea?

Mr. **Cook**. Korea, right now. But we are susceptible for European firms, too.

Senator **Chafee**. Yes.

All right. Well, thank you very much.

You heard Mr. Chapoton ask whether it is really a problem. Speaking on behalf of Blount, you said it has been a problem. Are there any other illustrations you can make for the record?

Mr. **Cook**. No, but there is no way we can be competitive, with having to take a 15-percent tax and not have it as a deduction.

Senator **Chafee**. You gave the example of Malaysia are they going to be satisfied if the work is done overseas rather than done in your home office? Or are they just trying to work it out so the work will be done there, period?

Mr. **Cook**. Well, in my personal judgment, there are two alternatives. They would like the work to be done there, No. 1; but, No. 2, they are trying to increase technology in their own countries, and I think this is one of the incentives for them to keep this tax in place.

Senator **Chafee**. All right, fine. We might be after you for further specific illustrations of the problem—you, or the AGC.

Mr. **Cook**. Yes.

Senator **Chafee**. Thank you very much, Mr. Cook and Mr. Fisher.

Mr. **Cook**. Thank you.

Mr. **Fisher**. Thank you.

Senator **Chafee**. All right, the panel on S. 1557: Mr. Evans, Mr. Rey, and Mr. Coles.

How did we get so many people? Who is who here?

Mr. **Evans**. Only two speakers, Mr. Chairman. We have people with us here who are not on the panel.

Senator **Chafee**. OK. Why doesn't everybody here identify themselves? Mr. Evans, do you have someone with you?

Mr. **Evans**. No, and I am John C. Evans, advisory director of Morgan Stanley and Co.

Senator **Chafee**. All right. Why don't we start on the left, so I'll know who's who here.

Mr. **DuBeer**. Walter DuBeer, vice president of Morgan Guaranty Trust.

Mr. **Rey**. Nicholas Rey, managing director, Merrill Lynch.

Senator **Chafee**. Mr. Evans.

Mr. **Coles**. Michael Coles, partner, Goldman Sachs and Co.

Mr. **Loverd**. Bob Loverd, managing director of First Boston.

Mr. **Shinkle**. John Shinkle, general counsel, Salomon Brothers.

Senator **Chafee**. All right. Now, did each of you have a statement? Or Mr. Evans, are you going to be the spokesman? Mr. Evans, Mr. Rey, and Mr. Coles, is that the arrangement?

Mr. **Evans**. Mr. Chairman, we would request that Mr. Coles speak first. He is representing the Securities Industry Association with which we are all associated, and that that be followed by a brief statement from Mr. Rey, and a very brief one, if anything needs to be said by then, from me.

Senator **Chafee**. I take it there is no substantial disagreement on the panel on this, is there?

Mr. **Evans**. That's correct.

Senator **Chafee**. I suspected that.

All right, Mr. Coles, why don't you proceed?

STATEMENT OF MICHAEL H. COLES, PARTNER, GOLDMAN SACHS, NEW YORK, N.Y., ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. **Coles**. Thank you, Mr. Chairman.

We are a subcommittee of the Securities Industry Association, whose objective is to preserve access of U.S. borrowers to offshore debt markets. We appreciate the opportunity to appear before you this afternoon to testify in favor of S. 1557, which we believe will significantly expand U.S. borrowers' access to overseas debt markets. We have submitted our full testimony in writing, and in the interests of time I am just going to emphasize some key points.

The Eurobond market is a sizable, growing, viable bond market where debt securities mostly of longer-term maturity are sold to a largely institutional international investor base.

In 1982, the total volume of issues in this market was close to $70 billion. U.S. issuers accounted for $14.6 billion, or 21 percent of this market. This is a market, therefore, in which investors have plenty of alternatives, in which withholding tax free interest payments are the norm, and which will continue to flourish with or without U.S. issuers. To compete in this market, U.S. issuers must offer an instrument tailored to the needs of investors, including complete freedom from withholding taxes.

The $14.6 billion raised in the Euromarket accounted for 28 percent of all U.S. corporate borrowings in 1982.

Senator **Chafee**. That's a significant figure, isn't it? Where is that in your testimony, Mr. Coles?

Mr. **Coles**. It is in one of the exhibits, sir.

Senator **Chafee**. Oh, I see. Did you say 28 percent of the borrowing?

Mr. **Coles**. 28 percent. It is in exhibit 5, sir.

Senator **Chafee**. I see. Thank you.

Mr. **Coles**. Over the past 20 years, U.S. private sector issuers have been able to access the Eurobond market free of withholding tax by means of Netherlands Antilles subsidiaries. Public sector borrowers, including the Treasury, lack such ability and have been denied access to these markets.

We believe that S. 1557 represents a preferable method of providing continued and broadened access to this important market. On the other hand, we are very concerned that failure to renegotiate the Netherlands Antilles tax treaty or some other event might prevent U.S. corporations from continuing to access the Eurobond

Market, with results which in our judgment would be extremely adverse:

First, severe pressure on domestic markets—a 33-percent increase in new issue volume, based on the 1982 figures.

Second, consequential dislocation of our financial markets.

Third, interest rates above those otherwise prevailing and increased market volatility.

Fourth, the possible squeezing of lower quality borrowers out of the U.S. markets.

And fifth, and very important in today's environment, an increased conflict between private sector and U.S. Government needs.

Now, our concern is heightened even more if withholding taxes are imposed on outstanding Eurobond issues, which presently amount to some $32 billion. We believe that issuers would take advantage of their prepayment rights to retire this debt and refinance it in domestic markets. Quite obviously, this would further aggravate the problems I have described earlier.

S. 1557, in our judgment, will permit U.S. corporations to finance freely overseas, will encourage the flow of investment funds into our domestic, private, and government markets, will enhance U.S. tax revenues according to Treasury estimates, which we believe to be conservative, by some $35 to $50 million.

We, therefore, strongly support the continued and broadened access to overseas debt markets which S. 1557 will provide.

Mr. Chairman, we intend to review the record of these hearings. We would like your permission to permit further comments in writing if desirable.

Senator CHAFEE. Oh, yes.

Mr. COLES. Thank you, sir.

Senator CHAFEE. Within 10 days.

Mr. COLES. Yes, sir.

Senator CHAFEE. Now, wait a minute. You wanted to review the record of the hearing to make comments? What I am thinking about is when you will be able to get the record in order to make your comments.

Mr. COLES. Mr. Chairman, I was thinking particularly of the report of the staff of the Joint Committee of Congress on Taxation, which I believe will be available shortly.

Senator CHAFEE. OK. Apparently that is available. Why don't you—September 16. Just make sure you get copies. Now, how much time do you want to get your comments in?

Mr. COLES. I think 10 days will be adequate, if we may have it, Mr. Chairman.

Senator CHAFEE. Fine. That is perfectly satisfactory.

STATEMENT OF NICHOLAS A. REY, MANAGING DIRECTOR, MERRILL LYNCH WHITE WELD CAPITAL MARKETS GROUP, NEW YORK, N.Y.

Mr. REY. I am Nicholas Rey, managing director for Merrill Lynch. I want to just add one or two comments very briefly.

A concern has been expressed recently about the removal of withholding tax, that as a measure which would stimulate the inflow of foreign capital to the United States, it would tend to increase the value of the dollar thereby making our exports more difficult and increasing imports into the United States.

We, as a group, do not believe that that is correct. We start from the basis that there are $770 billion worth of dollars in the hands of foreigners outside of the United States today.

The first effect of this bill would be to shift some of those dollars into the U.S. market. That is, we are talking about a shift of dollars abroad to dollars in the United States—not dollars across the exchange markets, that is, people changing from Deutsche marks into dollars, but dollars into dollars. Therefore it will not have an impact of increasing the value of the dollar.

On the other hand and more importantly, the measure would tend to reduce interest rates in the United States by increasing the flow of foreign dollars into the United States. This would tend to reduce the value of the dollar and indeed help the U.S. trade position over time.

Senator CHAFEE. I didn't get that first argument that you were worried about?

Mr. REY. Well, let me try it again. The argument goes that since foreigners hold foreign currency, they would shift from their foreign currency holdings—that is, take their Deutsche marks and buy U.S. dollars, increasing the value of the U.S. dollar in the process—in order to invest in the United States.

Our contention is that there is such an enormous pool of dollars already in the hands of foreigners, that what we are merely talking about here to a large extent is a shift of dollars that exist outside of the United States into the United States, rather than a shift across exchange markets.

Senator CHAFEE. I see.

All right.

Mr. REY. A final point that I would like to bring to your attention, Mr. Chairman, is that this is going to be a very unique opportunity for the Congress if it has a chance to vote on this measure, because it is one of the few times that the Congress can vote for a reduction in taxes, an increase in savings, and an increase in the revenues of the U.S. Treasury. That doesn't happen often in one's lifetime.

I would like to pass the microphone over to Mr. Evans for one final comment.

Senator CHAFEE. Mr. Evans, you have been the gentleman who has worked longest and hardest on this. So it is fitting that you appear here today to give your comments.

STATEMENT OF JOHN C. EVANS, ADVISORY DIRECTOR, MORGAN STANLEY & CO., INC., NEW YORK, N.Y.

Mr. EVANS. Well, Mr. Chairman——

Senator CHAFEE. By the way, this has passed the Senate in prior years, hasn't it, Mr. Evans?

Mr. EVANS. It was reported out not in the Senate but in this committee unanimously in late 1979. I don't believe that it passed the Senate in 1976. I just can't answer that question.

I would like to point out, however, that it has had the strong support of the last four administrations—Republican and Democratic—and in its present form, which does not apply to bank loans, it has received the support of the Federal Reserve Board.

Other than that, I would like to associate myself with the Securities Industry Association statement, in preparation of which I participated, and open myself along with my associates here to your further questions.

[The prepared statement of the previous panel follows:]

STATEMENT OF

MICHAEL H. COLES
PARTNER
GOLDMAN, SACHS & CO.

ROBERT L. LOVERD
MANAGING DIRECTOR
THE FIRST BOSTON CORPORATION

NICHOLAS A. REY
MANAGING DIRECTOR
MERRILL LYNCH WHITE WELD CAPITAL MARKETS GROUP

WALTER A. GUBERT
VICE PRESIDENT
MORGAN GUARANTY TRUST COMPANY

JOHN C. EVANS
ADVISORY DIRECTOR
MORGAN STANLEY & CO., INCORPORATED

JOHN T. SHINKLE
GENERAL COUNSEL
SALOMON BROTHERS INC

ON BEHALF OF THE
SECURITIES INDUSTRY ASSOCIATION

ON S. 1557

BEFORE THE

UNITED STATES SENATE
COMMITTEE ON FINANCE

September 19, 1983

My name is Michael H. Coles and I am a Partner of Goldman, Sachs & Co. With me are Robert L. Loverd who is a Managing Director of The First Boston Corporation, Nicholas A. Rey who is a Managing Director of Merrill Lynch White Weld Capital Markets Group, John C. Evans who is an Advisory Director of Morgan Stanley & Co., Incorporated and John T. Shinke who is General Counsel for Salomon Brothers Inc.

We appreciate this opportunity to appear before the Senate Finance Committee and are here in our capacities as members of a special sub-committee of the Securities Industry Association which has as its primary objective the preservation of access to overseas capital markets by United States borrowers. In addition to our firms, Morgan Guaranty Trust Company participates in the sub-committee in the capacity of an interested observer and is represented by Walter A. Gubert who is a Vice President of the bank. Combined, these six firms lead managed 99 of the 133 dollar-denominated Eurobond issues completed by U.S. corporations in 1982.

We appear here to testify in favor of S. 1557 which was introduced by Messrs. Chafee and Bentsen and would eliminate the 30% withholding tax on interest paid to foreign portfolio investors in U.S. bonds and foreigners who lend us money on a long term basis. There is of course no tax on interest paid to foreigners who lend us short term money. We view S. 1557 as a means of significantly expanding access to overseas investors on the part of U.S. borrowers, and we support it in that context. We are aware of the Treasury Department's estimate that S. 1557 would produce a revenue gain of some $35 to $50 million and we believe that the estimate is reasonable and conservative. Currently, American companies raise money abroad free of withholding tax by using Netherlands Antilles subsidiaries. Should S. 1557 not be enacted, it is imperative that this form of access to foreign investors be maintained by means of a revised United States - Netherlands Antilles Tax Treaty or otherwise.

Current Law

Under current law, the United States imposes a tax of 30% on interest payments made to foreign investors. This tax is collected in its entirety by withholding it at its source and is therefore called a withholding tax. Although the 30% rate may be reduced by existing tax treaties, such treaties as a practical matter are not relevant for debt obligations publicly offered outside the United States.

American debt obligations, burdened with this tax, must compete with securities sold in the Eurodollar bond market which are not subject to any so-called withholding tax.* The net effect of the U.S. tax, in most cases, would be to reduce the return to overseas investors on interest-bearing securities issued in the United States by up to 30%. This reduced return would make United States Government and corporate obligations decisively uncompetitive with alternative investments available in the Eurodollar bond market. The tax has created an insurmountable barrier to investment in United States Government and corporate debt securities by most foreign private individuals and institutions. As a practical matter, therefore, debt securities cannot be sold to foreign private sector investors if they are subject to the 30% withholding tax.

Although direct access to overseas investors is effectively precluded by the 30% withholding tax, U.S. corporations have been able to sell their debt securities outside the United States free of the withholding tax by means of indirect access through Netherlands Antilles subsidiaries. Netherlands Antilles subsidiaries have been employed for this purpose for almost 20 years. Funds raised by U.S. corporations in this manner amounted to $14.6 billion in 1982, up from $4.4 billion in 1980 and $1.5 billion in 1978; since 1974, over $32 billion of such overseas issues have been completed by U.S. corporations.

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* See the discussion of the withholding tax practices of other countries on page 7.

The Securities Industry Association Position

We are concerned that events might occur which would inadvertently result in the termination of future access to overseas capital markets and/or the prepayment of the approximately $32 billion of overseas issues which have been completed by U.S. corporations since 1974. We are aware that the U.S. Treasury Department is presently renegotiating the United States/Netherlands Antilles Tax Treaty. Separately, the Internal Revenue Service which had long approved the use of Netherlands Antilles subsidiaries, through its district offices has recently raised certain questions with regard to the application of withholding tax to interest paid on Eurobonds. This activity on the Service's part could have a substantial and adverse effect on U.S. corporations which have outstanding Eurobonds, and on future borrowings in the Eurobond market. The SIA is concerned that the foregoing administrative developments, absent enactment of S. 1557, could produce severe financial consequences.

The SIA supports S. 1557 and wishes to focus your attention on the size of overseas capital markets, the degree of U.S. corporate involvement in them and the extent to which continued access to those markets is in this nation's self-interest. We also concur with the Treasury's conclusion that S. 1557, if enacted, will have a positive effect on tax revenues.

Importance of Access to Capital Markets Outside the United States

The attached eight exhibits highlight the growth and current size of capital markets outside the United States and detail their increasing importance as a source of financing for American borrowers. If S. 1557 were not passed and if a suitable alternative means of accessing the Eurobond market free of withholding tax (such as a Netherlands Antilles subsidiary) were not available, overseas capital markets would be closed to future offerings by U.S. corporations and the following scenario might unfold:

- Domestic capital markets would experience severe pressures. For instance, had the $14.6 billion of Eurobond issues completed during 1982 been sold instead in the domestic market, new issue volume in the latter market would have increased 33% from $43.7 billion to $58.3 billion. We believe that this supply could not have been absorbed in an orderly manner. In a sense, therefore, overseas markets have functioned during recent years as an effective means of reducing pressure on domestic markets.

- The impact of these events would be particularly disruptive if pressures from the funding of present and future needs were combined at a point in time with the necessity of refunding the $32 billion of outstanding issues (see the last bullet point on the fifth page).

- As many U.S. corporations which financed in the Eurobond market during recent years were of extremely high credit quality, their return to the United States could tend to squeeze lower quality issuers out of domestic markets.

- The increase in the private sector's domestic funding activities would be in direct conflict with those of the U.S. government as it attempts to finance its budgetary deficit.

- It is highly unlikely that any significant portion of overseas investment funds which would otherwise have been employed for the purchase of Eurobond obligations of U.S. corporations would find their way back to the United States. A portion of such funds might be temporarily deposited with banks. However, shortly thereafter they would be invested in the debt obligations of those non-U.S. issuers which have free access to international capital markets.

- The net impact of this scenario would be that U.S. capital markets would experience severe volatility and that domestic interest rates would settle at levels above those which would otherwise prevail. Moreover, certain U.S. corporations would have diminished access to domestic capital markets.

In the event that U.S. withholding taxes were imposed on interest payments on presently outstanding Eurobond issues, the following events might occur:

- Most of the $32 billion of Eurobond issues sold since 1974 would be prepaid by their issuers. Otherwise, these same corporations would be legally obliged to gross up their interest payments on outstanding Eurobond issues by as much as 43%.

- Initially, these prepayments would be financed in U.S. dollars largely through bank loans and the issuance of commercial paper, primarily in the United States but also overseas. This would result in upward pressure on short term interest rates in the United States.

- The balance sheet liabilities of impacted U.S. corporations would, by historical standards, reflect a sharp increase in short term debt and an equivalent decrease in long term debt. This would occur at a time when the short term debt to total debt ratios of U.S. corporations are at historically high levels — levels which have in part caused major American rating agencies to downgrade the credit ratings of many corporations.

- To restore their balance sheet equilibrium, corporations probably would seek to refund their Eurobond issues with new domestic bond issues. As many of the offerings completed between 1974 and 1979 bear low coupons by today's standards, the interest expense of these corporations would increase (certain of the corporations with lower credit ratings might find it impossible to finance in domestic public or even private markets). While the refunding of issues completed during the 1980-82 high interest rate era might be completed at lower interest rates, such refundings would deprive overseas investors of their investment returns and could be expected to materially jeopardize relationships between the United States and the overseas investment community.

- Domestic capital markets would experience severe dislocations and interest rates would, at least for a time, move sharply upward.

- To put the $32 billion (plus accrued interest) refunding requirement in context, the average annual new issue volume of taxable fixed income securities in domestic capital markets in the 1979/82 period was $39 billion. Therefore, the refunding alone would be equivalent to almost one full year's activities in domestic capital markets.

Importance of Encouraging Capital Inflows to U.S. Capital Markets

In 1982, foreign investors were the source of $17.2 billion of net purchases of Treasury and federal financing bank bonds and notes; in the same year, foreign net purchases of U.S. corporate securities was a mere $1.6 billion. Our experience suggests that the vast majority of these investments were made by foreign central banks which are exempt from U.S. withholding taxes. Private sector investors (as opposed to central banks) tend to be the principal purchasers of corporate securities; we believe that their absence from the U.S. corporate market is due to the existence of the U.S. withholding tax coupled with the availability of attractive investment alternatives outside the United States. Thus, S. 1557 would remove the most important obstacle to capital inflows.

While potential incremental flows in a non-withholding tax environment cannot be predicted with any precision, surveys performed several years ago by Merrill Lynch and Morgan Stanley estimated incremental flows into Treasury and corporate securities of at least seven billion dollars. These figures do not necessarily constitute the net incremental flow to American borrowers which would result were U.S. withholding taxes eliminated. Were S. 1557 passed, it is likely that a significant portion of the $14.6 billion of funds raised by U.S. corporations in capital markets outside the United States in 1982 would not have been funded in that manner. Rather, most of those corporations would have elected to raise capital through SEC-registered offerings which would be sold, in part, to overseas investors. Thus, it is possible that under S. 1557, U.S. corporations would cut back on their new issue activities overseas and substitute for them domestic offerings which are sold in part to the same overseas investors which could have purchased the Eurobond issues.

Withholding Tax Practices Outside the United States

Debt obligations sold in the Eurobond market are invariably free of taxes withheld at the source. This freedom from withholding taxes may be based on a specific exemption for interest on specified foreign borrowings (as, e.g., in the case of Canada, France, the United Kingdom and Australia), on the absence of any withholding tax on interest (as, e.g., in the case of the Netherlands, Denmark and Finland) or on the use of foreign finance subsidiaries (as, e.g., in the case of Germany). Foreign countries whose issuers have borrowed in the Eurobond market without withholding tax include the following:

- Algeria
- Argentina
- Australia
- Austria
- Brazil
- Belgium
- Canada
- Chile
- Colombia
- Costa Rica
- Denmark
- Finland
- France
- Germany
- Greece
- Hungary
- Iceland
- India
- Indonesia
- Israel
- Iran
- Ireland
- Italy
- Japan
- Korea
- Luxembourg
- Malaysia
- Mexico
- Netherlands
- New Zealand
- Norway
- Papua New Guinea
- Philippines
- Portugal
- Singapore
- South Africa
- Spain
- Sweden
- Switzerland
- Trinidad & Tobago
- Thailand
- United Kingdom
- Venezuela
- Yugoslavia

Borrowers in the Eurobond market also include international organizations (such as the World Bank and the Asian Development Bank) and multinational organizations (such as the European Investment Bank and the European Economic Community).

Revenue Enhancing Aspects of S. 1557

The SIA believes that S. 1557 will encourage the flow of foreign capital into the United States and will also result in a net increase in tax revenues to the United States. Regarding the latter subject, in a letter to the Hon. Sam M. Gibbons dated May 23, 1983, John E. Chapoton, Assistant Treasury Secretary for Tax Policy stated that "direct issuance of Eurobond obligations by U.S. issuers, as envisioned by your proposal, would result in a net gain in U.S. revenues" and that "the net revenue gain from such an amendment to the Internal Revenue Code would on a conservative basis be $35 million, and could well be as much as $50 million."

The SIA has on its own considered the potential revenue gain which would result from enactment of S. 1557. By making the employment of Netherlands Antilles finance subsidiaries unnecessary, enactment of S. 1557 would eliminate payments of Netherlands Antilles income tax made by such subsidiaries which, in turn, would eliminate the foreign tax credit taken for such taxes and thereby increase U.S. tax revenues. The magnitude of the revenues thus raised is difficult to quantify with certainty, largely because the Netherlands Antilles income tax varies with the finance subsidiary's debt to equity ratio, use of proceeds and other factors. Notwithstanding these information constraints, the SIA believes that the Treasury Department's estimate of a $35-50 million revenue gain is reasonable and conservative.

Existing Withholding Tax Uncertainties

The present environment is one in which a number of private sector borrowers are reluctant to take advantage of the net-cost-of-money savings and to exploit other opportunities available in capital markets outside the United States because of the uncertainty related to the future withholding tax status of interest payments on such obligations. This uncertainty is attributable to (a) the unknown status of S. 1557, (b) the renegotiation of the U.S./Netherlands Antilles Tax Treaty and (c) the Internal Revenue Service challenges to the tax status of certain existing Netherlands Antilles subsidiaries.

Equally important is the fact that for policy reasons a number of very important sectors of the economy have been deprived of access to the vast funds available outside the United States. In particular, the Federal National Mortgage Association, which has publicly stated its eagerness to tap those markets, has been denied the opportunity to do so. Moreover, the world's single largest issuer of coupon securities, the United States Treasury, is precluded by the U.S. withholding tax from directly attracting foreign private sector investors.

Conclusion

The SIA believes that continued and broadened access on the part of U.S. borrowers to overseas fixed income investors is of vital interest to this nation's financial health and that both S. 1557 and a suitably renegotiated U.S./Netherlands Antilles Tax Treaty could attain this objective. Of the two alternatives, S. 1557 is the broadest and the only one which would both facilitate capital flows into the United States and result in a net increase in U.S. tax revenues. As well, S. 1557 would tend to integrate the two principal dollar capital markets (the domestic market and the Eurodollar market) under U.S. influence, with the result that more Americans would find employment in this country's financial services sector.

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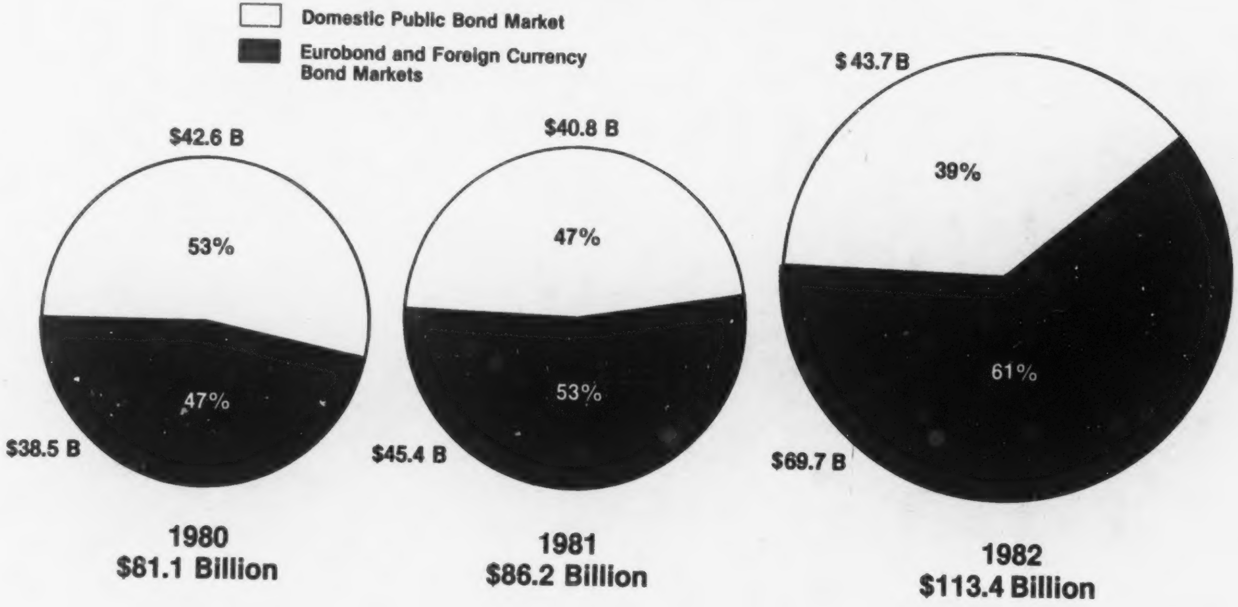
Exhibit 8 Illustrative Cost Savings

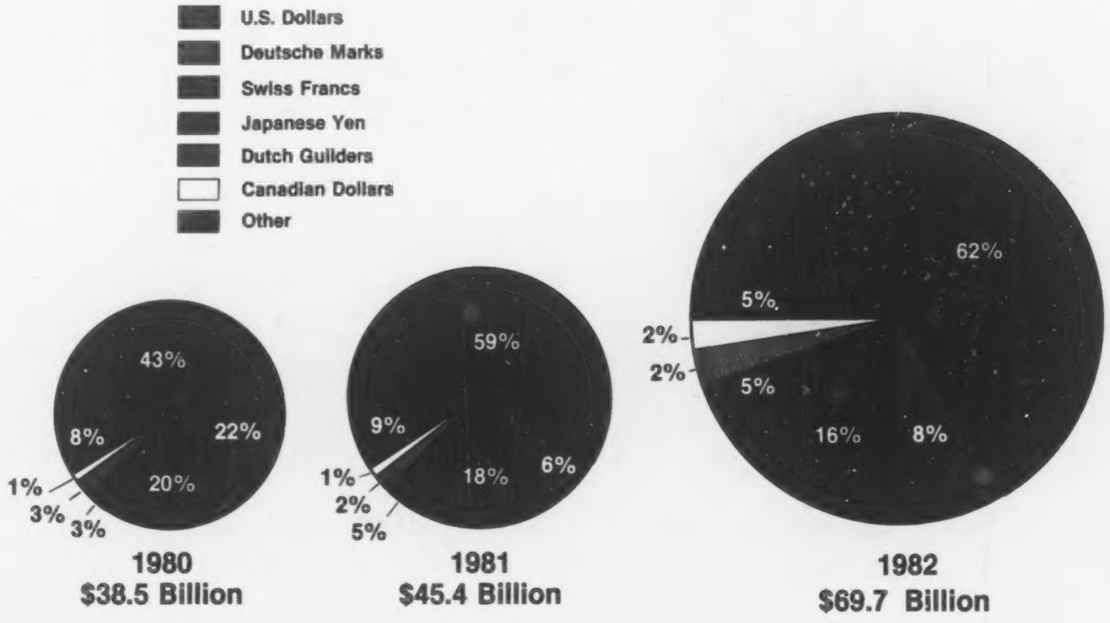
Principal Capital Markets of the World

Overseas capital markets accounted for 47% of funds raised in 1980 and 61% of a much enlarged market in 1982. Conversely, the domestic market shrank from 53% in 1980 to 39% in 1982.



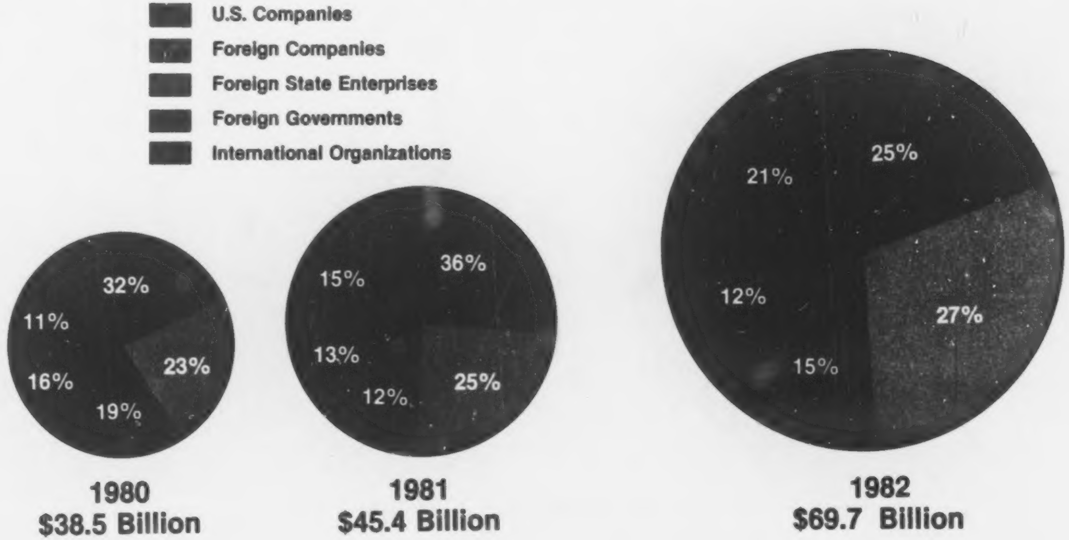
Eurobond and Foreign Currency Bond Market by Currency of Denomination

Between 1980 and 1982, total new issue volume in the Eurobond and foreign currency bond markets grew 81% and the share of U.S. dollar denominated issues increased from 43% to 62%.

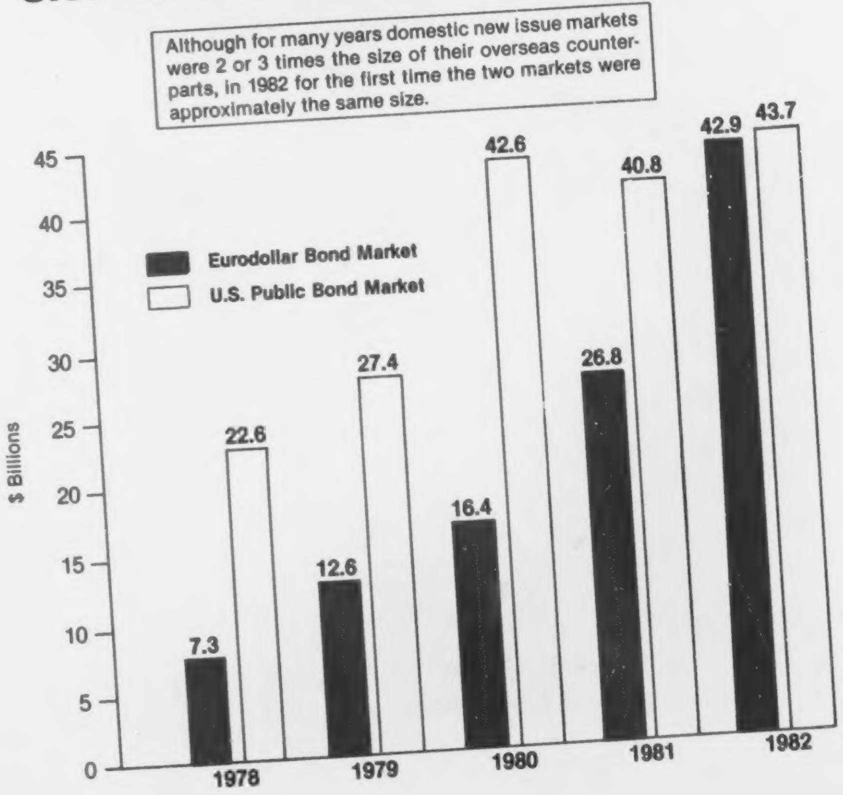


Nature of Borrowers in the Eurobond and Foreign Currency Bond Markets

U.S. issuers represented 11% of new issue volume in 1980 and 21% in 1982.



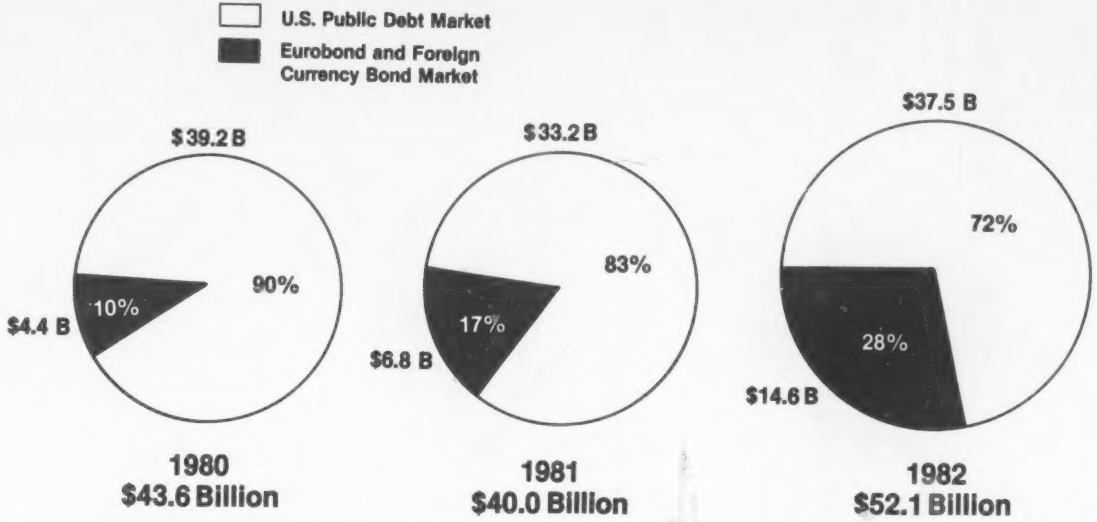
New Issues by All Borrowers in the U.S. Public and Eurodollar Bond Markets



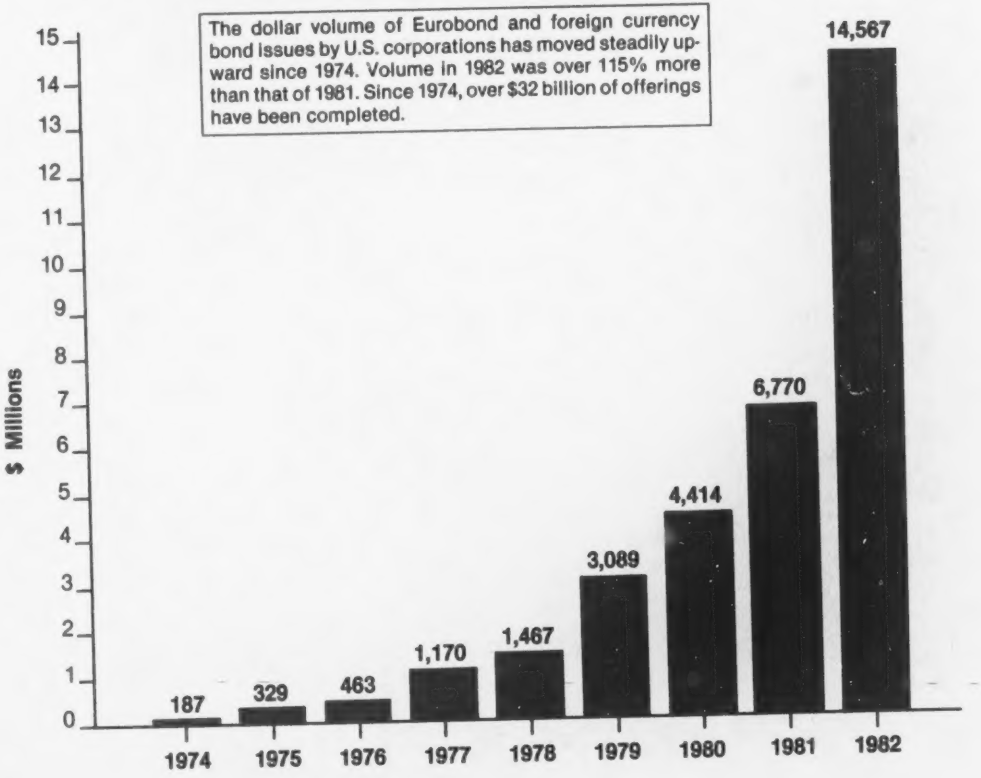
Although for many years domestic new issue markets were 2 or 3 times the size of their overseas counterparts, in 1982 for the first time the two markets were approximately the same size.

New Issues by American Corporations in the U.S. and Overseas Markets

Overseas capital markets have accounted for an increasing percentage of U.S. corporate public debt financing. In 1962, approximately 28% of public debt financing by U.S. corporations was completed in capital markets outside the United States.



Overseas Issues by U.S. Corporations



The dollar volume of Eurobond and foreign currency bond issues by U.S. corporations has moved steadily upward since 1974. Volume in 1982 was over 115% more than that of 1981. Since 1974, over $32 billion of offerings have been completed.

U.S. Corporations Which Have Utilized The Dollar Sector of the Eurobond Market

(January 1975 - December 1982)

A substantial number of U.S. companies have turned to the Eurodollar bond market as an alternative to the U.S. public market.

	Number of Issues	Dollar Volume (in millions)
Aetna Life and Casualty Company	1	150.0
Alaska Interstate	1	40.0
Alco Standard Corporation	1	30.0
Amax Inc.	1	75.0
American Airlines, Inc.	1	55.0
American Express International Banking Corp.	1	40.0
American Express Overseas Credit Corporation	1	75.0
American Medical International, Inc.	3	475.0
American Natural Resources Company	1	50.0
American Telephone & Telegraph Company	1	400.0
Anacomp Inc.	1	12.5
Anheuser - Busch, Inc.	2	200.0
Anixter Brothers Inc.	1	20.0
Apache Corporation	2	50.0
Arizona Public Service Co.	5	270.0
Armco Inc.	1	50.0
Ashland Oil, Inc.	1	60.0
Atlantic Richfield Company	2	700.0
Avco Corp.	2	45.0
Baker International Corporation	2	265.0
Bankers Trust New York Corporation	1	200.0
Bank of America	2	300.0
Beatrice Foods Co.	2	350
Beneficial Corporation	3	300
Blocker Energy Corporation	1	25.0
Burroughs Corporation	1	50.0
CPC International Inc.	1	50.0
Campbell Soup Company	2	250.0
Carolina Power & Light Company	1	60.0
Carter Hawley Hale Credit Corp.	1	50.0
Caterpillar Tractor Co.	3	540.0
The Charter Company	1	50.0
Chase Manhattan Corporation	1	150.0
Chemical New York Corporation	1	150.0
Citicorp	15	2,651.5
Cities Service Co.	1	150.0
City Investing Co.	2	80.0
Coca-Cola Bottling Company of New York Inc.	1	30.0

	Number of Issues	Dollar Volume (in millions)
The Coca-Cola Company	1	100.0
Commercial Credit Corporation	1	50.0
Community Psychiatric Centers	2	30.0
The Continental Group, Inc.	1	100.0
Continental Illinois Corporation	3	450.0
Crocker National Bank	1	225.0
Crutcher Resources Corporation	1	30.0
Digicon Inc.	1	18.0
Walt Disney Productions	2	175.0
Dow Chemical Co.	1	200.0
Dresser Industries, Inc.	1	75.0
Duke Power Company	1	60.0
Dynalectron Corporation	1	15.0
E.I. duPont de Nemours	6	1,315.0
ENSERCH Corporation	1	50.0
Esterline Corporation	1	20.0
Fairchild Camera and Instrument	1	20.0
First Chicago Corporation	1	100.0
First National Boston Corporation	1	100.0
Fluor Corporation	2	150.0
Ford Motor Company	2	450.0
Ford Motor Credit Company	3	450.0
Fruehauf Corp.	1	20.0
Fuqua Industries Inc.	1	50.0
Galaxy Oil Company	1	15.0
Galveston-Houston Company	2	30.0
Gearhart-Owen Industries Inc.	1	30.0
General Electric Credit Corporation	6	1,800.0
General Foods Corporation	1	100.0
General Motors Acceptance Corp.	15	2,275.0
General Motors Corporation	2	200.0
General Telephone & Electronics Corporation	7	380.0
Georgia-Pacific Corporation	1	65.0
Getty Oil Company	1	125.0
Goodyear Tire & Rubber Company	1	75.0
Gould Inc.	2	70.0
W.R. Grace & Company	1	75.0
Gulf States Utilities Company	2	120.0
Gulf Oil Corporation	4	675.0
Gulf & Western Industries, Inc.	4	135.0
The Hertz Corporation	1	50.0
Helmerich & Payne, Inc.	1	60.0
Hexcel Corporation	1	10.0
Hospital Corporation of America	2	105.0
Household International, Inc.	1	100.0
Huffy Corporation	1	10.0
IC Industries, Inc.	4	220.0
INA Corporation	2	100.0
IU International Corp.	2	65.0

	Number of Issues	Dollar Volume (in millions)
Illinois Power Company	1	50.0
Ingersoll - Rand Co.	1	50.0
International Business Machines Corp.	5	660.0
International Harvester Co.	1	115.0
International Standard Electric Corporation	1	100.0
International Telephone & Telegraph Corporation	1	75.0
Itel Corp.	2	55.0
John Hancock Mutual Life Insurance Company	1	75.0
J.P. Morgan & Co. Incorporated	1	250.0
K - Mart Corp.	2	136.0
Kansas Gas and Electric Company	1	40.0
Kay Corporation	2	35.0
Kennecott Corp.	1	100.0
Kidde, Inc.	1	50.0
Lear Petroleum Corporation	2	70.0
Lifemark Corporation	1	25.0
MGF Oil Corporation	1	35.0
McDonnell Douglas Corp.	2	90.0
McGraw - Edison Co.	1	75.0
Manufacturers Hanover Corporation	3	300.0
Marine Midland Banks, Inc.	1	125.0
Marion Corporation	1	20.0
Massey - Ferguson Inc.	2	115.0
Marriott Corp.	1	12.5
Merrill Lynch & Co., Inc.	2	200.0
Miles Laboratories, Inc.	1	20.0
Mobil Oil Corporation	1	500.0
Montana Power Company	2	100.0
Moran Energy Inc.	1	50.0
NICOR Inc.	1	50.0
Natomas International Corporation	3	150.0
Newmont Mining Company	1	50.0
The New York Times Company	1	50.0
Niagara Mohawk Power Corp.	1	50.0
Northern Indiana Public Service Co.	1	50.0
Northwest Energy Company	1	40.0
Northwest Industries, Inc.	1	50.0
Northwest Natural Gas Company	1	40.0
Oak Industries	1	35.0
Occidental Petroleum Corp.	7	350.0
Ohio Edison Co.	2	125.0
Optical Coating Laboratory Inc.	1	15.0
Pacific Gas & Electric Co.	3	180.0
Pacific Lighting Corp.	1	65.0
Pembroke Capital Company Inc.	2	300.0
Pengo Industries Inc.	1	22.5
J.C. Penney Company, Inc.	4	650.0
Pennwalt Corp.	1	25.0
Pennzoil Corporation	1	75.0

	Number of Issues	Dollar Volume (in millions)
Pepsico, Inc.	5	475.0
Philip Morris Credit Corporation	1	200.0
Phillips Petroleum Company	1	200.0
Portland General Electric Co.	2	100.0
Prudential Funding Corporation	1	150.0
Public Service of New Hampshire	1	30.0
Reading & Bates Corp.	1	25.0
Republic Steel Corp.	1	100.0
R.J. Reynolds Industries, Inc.	3	560.0
Reynolds Metals Company	1	60.0
The Saint Paul's Companies, Inc.	1	75.0
Santa Fe International Corp.	2	50.0
Sears Roebuck and Co.	4	1,050.0
Security Pacific Corporation	1	100.0
The Singer Company	1	50.0
South Carolina Electric & Gas Co.	1	60.0
Southern California Edison Co.	6	375.0
Southern California Gas Supply Co.	1	50.0
Spectra-Physics, Inc.	1	15.0
Sperry Corporation	1	100.0
Standard Oil Co. (Indiana)	1	75.0
Sundstrand Corporation	2	45.0
The Superior Oil Company	2	225.0
Tenneco Inc.	2	200.0
Texas General Resources, Inc.	1	12.0
Texas International Airlines, Inc.	3	90.0
Tosco Corporation	1	50.0
Trailer Train Co.	1	40.0
Transamerica Corp.	2	125.0
Transco Companies	2	100.0
Trans-Western Exploration Inc.	1	10.0
Tribune Co.	1	50.0
Triton Oil & Gas Corp.	1	20.0
Tyco Laboratories	2	32.0
U.S. Leasing International, Inc.	1	20.0
Union Carbide Corporation	1	150.0
Union Camp Corporation	1	70.0
United Technologies Corporation	1	100.0
Varco International Inc.	1	20.0
Jim Walter Corporation	1	25.0
Wang Laboratories, Inc.	1	40.0
Walt Disney Productions	2	175.0
Warner-Lambert Company	1	100.0
Wells Fargo & Co.	4	325.0
Xerox Corporation	1	100.0
Xerox Credit Corporation	1	250.0
Xidex Corporation	1	20.0

Illustrative Cost Savings in the Eurodollar Bond Market

1982

In addition to diversifying their funding sources, many corporations have tapped overseas markets because dollar funds were available on a lower cost basis than domestically.

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
11/18	**Arizona Public Service Company**	60	7	55
11/18	**General Foods Corporation**	100	12	44
11/17	**Bank of America Corporation**	100	7	108
11/17	**Gulf Oil Corporation**	100	12	99
11/16	**E.I. du Pont de Nemours**	100	12	51
11/11	**Coca Cola Company**	100	5.5	15
11/10	**General Electric Credit Corporation**	200	7	79
11/10	**Warner-Lambert Company**	100	7	43
10/19	**Superior Oil Company**	100	10	83
10/18	**Southern California Edison Company**	75	8	20
10/12	**The New York Times Company**	50	5	19
10/04	**United Technologies Corp.**	100	7	29
10/01	**Dresser Industries**	75	7	20
9/21	**Walt Disney Productions**	75	7	86
9/21	**Gulf Oil Corporation**	100	5	49
9/21	**Prudential Funding Corporation**	150	5	16
9/20	**Coca-Cola Company**	100	7	117
9/10	**General Electric Credit Corporation**	100	7	149
9/10	**RJ Reynolds Industries, Inc.**	100	7	97
9/09	**IBM World Trade Corporation**	200	10	63
8/17	**Southern California Gas Corp.**	50	7	24
8/16	**Sperry Corporation**	100	7	26

Offering Date	Guarantor	Amount ($ Millions)	Maturity (Years)	Net Cost of Money Savings Versus Domestic Market* (in basis points)
8/12	Pacific Gas and Electric Company	60	8	47
8/06	General Motors Acceptance Corporation	100	6	36
5/19	The Superior Oil Company	125	7	57
5/19	Illinois Power Company	50	7	59
5/17	Northwest Natural Gas Company	40	10	14
5/14	First National Boston Corporation	100	7	73
5/12	General Motors Acceptance Corporation	100	5	18
5/05	General Motors Acceptance Corporation	125	7	30
4/28	Union Carbide Corporation	150	7	31
4/23	Southern California Edison Company	75	7	63
4/16	Getty Oil Company	125	7	106
4/15	Phillips Petroleum Company	200	7	74
4/15	The Hertz Corporation	50	7	15
4/07	Campbell Soup Company	50	7	100
4/06	Bank of America NT and SA	200	5	89
3/30	Gulf States Utilities Company	60	8	78
3/25	Pacific Gas and Electric Company	45	7	53
3/10	American Telephone & Telegraph Company	400	7	46
2/19	Continental Illinois Corporation	100	7	14
2/11	Arizona Public Service Company	25	7	69
2/10	General Motors Acceptance Corporation	150	6	42
2/10	McDonnell Douglas Finance Corporation	50	7	8
1/26	Arizona Public Service Company	75	7	111

*The indicated savings compare the net cost of money on the Eurobond issue with what, in the SIA sub-committee's best judgment, would have been the net cost of money for an instrument of identical maturity in the domestic public market.

Senator **Chafee**. It has the support of everyone except the Netherlands Antilles. [Laughter.]

Well, I think what you say makes considerable sense. I believe, in the following panel, probably Mr. McIntyre will have some thoughts on this, representing the Citizens for Tax Justice.

It seems to me that the virtue of it is that it's going to open the U.S. capital markets to greater foreign investment than currently exists. Now, maybe it exists in a roundabout way, but there must be companies that are unable to take advantage of this convoluted method of getting the Eurodollars. Is that not so?

Mr. **Evans**. It is certainly so.

Mr. **Rey**. Mr. Chairman, if I might add a point on this, in fact this bill could be classified as a "small business measure," because today major corporations have the ability, with their banks of lawyers, et cetera, et cetera, and investment bankers like us, to use the Netherlands Antilles to raise money abroad. Those techniques are rather sophisticated and costly in and of themselves and are not so much available to the smaller and the medium-size companies in the United States. And this Bill, by permitting foreigners to invest in any fixed-income security in the United States would make it much easier for the small business to gain access to foreign savings.

Mr. **Coles**. I think, Mr. Chairman, the other major group of borrowers who are being denied this market, as I mentioned earlier, are the Federal Government and its agencies.

Mr. **Evans**. That's correct. And further, to your remark on the inflow of capital, Mr. Chairman, I think it should be clear to everybody—we are talking about long-term stable capital here: we are not talking about money that flows in anticipation of interest rate and exchange rate changes. Those funds utilize the short-term markets, the CD's Treasury bills, and commercial paper which today are exempt from this tax. We are talking about allowing foreigners to buy our long-term stable dollar obligations.

Senator **Chafee**. I must confess, I hadn't been aware of the long-term U.S. bond situation. explain again, the long-term Government obligations with respect to foreigners.

Mr. **Coles**. Well, the only way that a U.S. issuer can access the foreign markets today is by the use of a Netherlands Antilles subsidiary, which by virtue of the various tax treaties enables the interest to be paid to the investor free of withholding taxes.

The Federal Government has been unwilling or unable to avail itself of the Netherlands Antilles, for rather obvious reasons, and thus such entities as Fannie Mae and the Federal Home Loan Bank as well as the Government itself have not been able to access these markets.

Senator **Chafee**. What about the effect on employment? I know that it is probably a marginal thing, and I think probably Mr. Chapoton was correct in saying it might be de minimus. But would this affect employment in any way in U.S. financial centers?

Mr. **Evans**. Directly in the financial centers? Yes. I can give an illustration in the case of my own firm. We have more people in our London office working in the Eurobond market, in which we are a leading manager today, than we had in our whole firm 15 years ago. Now, we have been forced to export those jobs to remain competitive, we are forced to be competitive in that market. So we have exported jobs, and the repeal of this tariff barrier I would anticipate would result in the reimportation of some of those jobs. Obviously, to the extent that interest rates tended to be lower, that would be in the direction of having a secondary effect on the economy as a whole in creating jobs, but it certainly wouldn't cost jobs.

Senator CHAFEE. Do you agree with that, Mr. Coles?

Mr. COLES. Yes, I would, sir. I think I would go slightly beyond that to say that it is hard to conceive that an inflow of capital into this country of the kind of size that we are talking about could fail to be beneficial, both in terms of jobs and the overall growth and stability of our business.

Senator CHAFEE. Also, I think you made the point, Mr. Coles, or maybe Mr. Rey did, it has a good chance of affecting interest rates, certainly helping to lower interest rates; don't you think?

Mr. COLES. I think that is correct, in that it would change the supply/demand equation for the capital in favor of an increased supply, and therefore hopefully lower interest rates. Certainly we believe the real danger is that if access to these markets is cut off it would have a very adverse effect on our interest rate environment.

Senator CHAFEE. Is that a clear and present danger?

Mr. COLES. There are an increasing number of corporations who, noticing the audits that are being conducted of some of the companies that have used the Netherlands Antilles along well tried and proven ground, being audited by the IRS, and are holding back from going to these markets pending the results of those audits.

It is clear to us that the penalty of finding out after the fact that the Netherlands Antilles route either does not work or is being disallowed for some reason would be to immediately turn off all users of that market.

Senator CHAFEE. Mr. Loverd, do you have any comments?

Mr. LOVERD. In general, we anticipate a continuation of the significant interest on the part of U.S. companies in going to the Euro-bond market. This would result in further tax payments flowing to the Netherlands Antilles Government which could flow to the U.S. Treasury.

In addition to the revenue enhancement aspects of the bill, this particular bill will preserve U.S. corporate access to the Eurobond market, may enhance capital inflows, may increase domestic employment, and will probably reduce domestic interest rates.

Senator CHAFEE. It is a virtuous bill.

Mr. LOVERD. It is, indeed.

Senator CHAFEE. And furthermore, it has Treasury's support, which is always nice.

Mr. Shinkle?

Mr. SHINKLE. No, I have nothing to add to my colleagues' statements.

Senator CHAFEE. Mr. Gubert?

Mr. GUBERT. No additional comments, sir.

Senator CHAFEE. OK, gentlemen. Thank you very much for coming. I appreciate it.

Mr. COLES. Thank you, Mr. Chairman.

Mr. **Evans**. Thank you.

Senator **Chafee**. The next panel, consisting of Mr. McIntyre, Mr. Burke, Mr. Franasiak, and Mr. Hannes.

All right, Mr. McIntyre.

Welcome, gentlemen, and we look forward to your testimony.

Mr. McIntyre, why don't you proceed first?

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, D.C.

Mr. **McIntyre**. Thank you, Mr. Chairman.

On behalf of Citizens for Tax Justice and the groups we represent, including the AFL–CIO, a number of other unions, public interest groups, and citizens groups around the country, and also on behalf of Michael J. McIntyre, a professor of law at Wayne State University who helped us in the preparation of this testimony, we would like to express our strong opposition to S. 1557.

Now, as we understand the theory behind this bill, the supporters hope that by repealing the withholding tax the United States could become, in effect, a major tax haven for international investors, and that the result would be to increase the supply of capital funds available in the United States.

Now, first of all, we don't think this is a defensible goal for U.S. tax policy. Second, we don't think it will work. And third, if it does work, we think it will hurt the economy both in the short and the long run.

Let me briefly summarize our testimony on these points:

First of all, it is very important to understand who we are talking about trying to attract funds from here. For most foreign investors who are honestly reporting their income at home, the withholding tax is quite irrelevant. Either they are exempt from tax under one of our treaties, as long as they give the information, or they are eligible for a foreign tax credit from their own country. The only people who are significantly affected by the withholding tax are people who don't want to report their income back in their home country. So we are talking about tax avoiders, or, more precisely, tax evaders. We are talking about people who are intent on cheating on their income taxes in their home country.

Now, is it defensible for U.S. tax policy to be encouraging that kind of cheating? We don't think so, and it's not just a philosophical point of view. We spend a great deal of effort here in this country trying to track down Americans trying to evade U.S. taxes through the use of foreign countries. We rely on information that we can encourage foreign countries to give us. If we become a major tax haven, that information is not going to be forthcoming in the future.

As to the economics of this issue, first of all, it seems to me, based on the experiences of other countries which have chosen to become tax havens, that it's unlikely that the United States will attract a great deal of new capital if the withholding tax is repealed.

Typically, what has happened in tax haven countries is that capital flows in to take advantage of the tax breaks, and flows right out again in search of the best investment opportunities. The Netherlands Antilles is a fine example. Their investment income the year before last was more than their GNP. There was plenty of money going through the Antilles, but almost none of it staying there.

Now, if I'm wrong, if in fact we do attract additional foreign capital, what will the results be? Well, the question is, first of all, what is the cause of our current problem with the dollar's exchange rate—which everyone agrees is very high and is reducing exports and increasing imports? Well, according to the President's Council of Economic Advisors, the problem is that foreigners are too eager to buy U.S. assets—financial assets, typically. As a result, the demand for dollars is up. As a result, the price of dollars is up. It's quite simple.

Now, if this bill succeeds in making U.S. financial assets more attractive, the short-run result is going to be to bid up the dollar. Now, that's going to hurt us in the short run by cutting our exports even further and increasing our imports even further, and it's going to hurt us in the long run as export markets that we have spent many years building are going to be hurt and as foreigners get a beachhead in importing into the United States.

So we think, from an economic point of view, this bill takes us in the wrong direction. We want foreigners to start buying our goods; we don't want them to continue to buy our assets.

So, in conclusion, let me say that we think that repeal of the withholding tax would be a mistake, a very serious one, one that may be irrevocable. It would increase the Federal deficit, despite Treasury's contentions to the contrary, and most of that benefit would go to tax evaders and to residents of oil-rich countries which have refused to enter into treaties with us.

To the extent that it would have an effect on inflows of capital, it would increase the exchange rate and therefore hurt us economically. It would turn us into a major tax haven, a disreputable step, which would undermine our ability to get cooperation with other jurisdictions to curtail the existing abuses of tax havens. And, finally, it would destroy any reasonable hope we have for needed reform of our system of taxing foreigners operating within our borders—which reforms, by the way, we think should move in exactly the opposite direction from that contemplated by S. 1557.

For all these reasons, we urge the subcommittees and the Congress to reject S. 1557.

Thank you.

Senator CHAFEE. OK. I think I'll hold questions until we hear from the other members of the panel.

Mr. Burke?

[Mr. McIntyre's prepared statement follows:]

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Statement of
Robert S. McIntyre, Director, Federal Tax Policy
Citizens for Tax Justice
&
Michael J. McIntyre, Professor of Law
Wayne State University
Before the Subcommittee on Savings, Pensions and Investment Policy
And the Subcommittee on Taxation and Debt Management
Of the Senate Committee on Finance
Concerning S. 1557, a Bill to Exempt Foreign Individuals and Corporations
From the 30 Percent Withholding Tax on Interest Income
September 19, 1983

We appreciate the opportunity to present our views to the Subcommittees today on S. 1557, which would repeal the current 30 percent withholding tax on interest paid to foreigners. We oppose the bill and urge the Subcommittees to reject it.

Over the past few years, the inflow of foreign investment funds into the United States has been enormous. At one time in our history, when U.S. investment abroad routinely exceeded foreign investment here, we might have welcomed this inflow. But under current economic conditions, with the net investment situation reversed,[1] the effects of the surge of foreign investment into the United States almost certainly are harmful. That inflow has been part of a process that has driven up the exchange rate on the dollar to an unhealthy level. As the 1983 *Economic Report of the President* explains:

> "What the rise of the dollar seems clearly to reflect is a rise not in the demand for U.S. goods, but in the demand for U.S. assets. . . . In order to buy U.S. assets, foreigners must first acquire dollars. The increased demand for dollars drives up the exchange rate."

The resulting harm to the American economy is very real, both in the short and the long run. In the short run, the overvaluation of the dollar has caused goods produced in America to be uncompetitive with foreign goods, thereby driving up our imports, reducing our exports, and costing many thousands of Americans their jobs. In the long run, it has given some foreign competitors a beachhead in the American marketplace and has destroyed export markets that took American firms many years to develop. Given all these bad effects, reducing long-term federal deficits and getting the government's fiscal house in order seem imperative. At the same time, Congress might want to consider measures that would directly regulate the inflow of foreign investment funds. Certainly, Congress should not want to enact legislation that might further stimulate these unhealthy inflows.

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[1] In the 1960-66 period, for example, U.S net investment abroad averaged $4.2 billion a year—or about 7/10 of one percent of the GNP. By the 1974-80 period, our net investment situation had moved roughly into balance, with a net capital outflow averaging a mere .06 percent of the GNP. But in the last four reported quarters (the second half of 1982 and the first half of 1983), net foreign investment into the United States totalled $25 billion—equal to about 8/10 of one percent of our GNP and the mirror image of the situation in the 1960-66 period. *See* the 1983 *Economic Report of the President*, at 55; U.S. Dept. of Commerce, Bureau of Economic Analysis, *The National Income and Product Accounts of the United States, 1929-76 Statistical Tables*, Table 4.1 (Sept. 1981) and *Survey of Current Business*, July 1983, Tables 1.1 and 4.1.

Congress could begin to stem the unhealthy inflows of foreign capital without the costs and administrative hassles of regulation by strengthening the current withholding tax on U.S. source investment income paid to nonresident aliens. Current law levies a 30 percent withholding tax on some types of investment income paid to foreigners, but the law has many loopholes and is superceded by tax treaties for payments made to residents of our important trading partners. Residents of treaty countries typically pay a withholding tax of 15 percent on dividends. Interest income is also taxed at 15 percent in some cases (e.g., Canada, Belgium), but the rates on interest income fall into no discernible pattern. In some cases, the treaties totally exempt interest income from U.S. taxation (e.g., Germany, the United Kingdom).

The first step toward strengthening the withholding tax on foreign investors would be to close the many loopholes in current law for short-term investments. For example, the provision of Internal Revenue Code Section 861(a)(1), which treats interest on U.S. bank deposits as foreign source income not subject to withholding, should be repealed. Congress should also require foreign taxpayers claiming treaty benefits to prove that they are bona fide residents of a treaty country and not, in fact, residents of a non-treaty country operating through a controlled corporation, a trust, or a nominee. Tough measures like these, coupled with more vigorous enforcement by IRS, could raise significant tax revenues and would help end the cynical tax avoidance games that foreigners and their American tax advisors are now playing, apparently with great success.

The second step toward a sensible withholding policy would be for Congress to urge the Treasury, through appropriate legislation, to renegotiate our many tax treaties to permit a uniform 15 percent withholding tax on payments of dividends and interest to all residents of treaty countries. The 15 percent rate is a widely accepted compromise between the legitimate claims for tax revenue of the country where the income arises and the country where the recipient of the income is resident. A standard 15 percent rate would simplify the administration of the withholding tax. A standard 15 percent rate, moreover, would significantly curtail the use of our tax treaties for tax avoidance, a problem that is particularly acute due to our tax protocol with the Netherlands Antilles, a notorious tax haven.[2]

2. The Internal Revenue Service's *SOI Bulletin* (Summer 1983) reports that "Recipients in the Netherlands Antilles, a tax haven, received more U.S. source income than those in any other foreign country in 1981 . . . . U.S. source income for 1981 ($1.4 billion) was greater than the Antilles' GNP ($1.2 billion)."

Although sound tax policy requires a tightening of our withholding tax on income paid to foreigners, Congress has been asked to consider legislation which would eliminate the withholding tax entirely on interest income. Repeal of withholding is favored by American financial intermediaries—banks and investment houses, for example—who believe that they could increase their profits by acting as middlemen for foreign "tax avoiders" seeking to make investments in the United States. It is common knowledge that many of these "tax avoiders" are common cheats, who are evading the taxes legitimately assessed in their home country.[3]

Misunderstanding the economic consequences of artificially stimulating inflows of foreign capital, the supporters of repeal of the withholding tax have argued that the 30 percent tax is a barrier to investment in the United States and have made fanciful claims about the jobs that would be gained by bringing new capital to America. In all likelihood, the impact of repeal on net capital inflows would be modest, as the experience of countries that have turned themselves into tax havens illustrates. What typically has happened is that funds flow into a tax haven to get the promised tax advantage and then flow out again for investment elsewhere, with the only economic benefits accruing to the financial intermediaries that arrange the several transactions involved. But if those arguing for repeal of withholding are correct—that repeal would actually cause a net increase in foreign capital flows into the United States—then they have unintentionally made a telling point against repeal, since increased foreign investment would tend to further boost the dollar and cause further harm and job loss to our export- and import-sensitive industries.

Quite apart from its desirable economic effects, the withholding tax is an important part of our system of international taxation for three reasons. First, unless the United States imposes a significant tax on income arising within its borders, it will become a tax haven that foreigners can employ to avoid taxes in their home country.[4] As a responsible member of the community of nations, the United States should not let itself be used in this fashion.

Second, fairness requires that foreigners earning income from U.S. sources should not enjoy a tax benefit that is, quite properly, denied to Americans. The United States cannot guarantee that foreigners will pay taxes according to their ability-to-pay, since the United States has limits on its jurisdiction to tax foreigners. But we can at least guarantee

[3] The March 1980 issue of *Euromoney* notes that proponents of repeal of the withholding tax hope it will help sales of bonds to "foreign buyers anxious to shelter themselves from their own tax burdens at home." (When repeal was proposed in 1980, it was rejected by Congress, just as Congress had refused to repeal withholding in 1976.)

[4] Testifying before the Ways and Means Oversight Subcommittee in 1979, Assistant Attorney General M. Carl Ferguson defined a "tax haven" as "a nation which affords secrecy to investors and permits the accumulation of wealth without any significant tax burden." *Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means Concerning Offshore Tax Havens*, 164 (April 1979). With no withholding tax and no disclosure requirements with regard to interest income earned by foreigners, the U.S. would come squarely within this definition

that these persons pay some reasonable amount of tax on their U.S. source income.[5]

Third, the statutory withholding tax is an essential part of our tax treaty strategy. Our basis treaty policy has three goals. First, we want to ensure that taxpayers engaged in international transactions pay taxes roughly comparable to the taxes paid by purely domestic taxpayers. Second, we want the revenue collected from taxpayers engaged in international transactions to be shared on some reasonable basis between the country where the income originates and the country where the taxpayer resides. And, third, we want to use the treaty process to obtain information about our own citizens' transaction abroad, so that we can penetrate illegal attempts to shelter income. To achieve these goals, we need the cooperation of foreign tax jurisdictions. Without the leverage provided by our 30 percent withholding tax, that cooperation will not be forthcoming in many instances.[6]

Repeal of the 30 percent withholding tax would be a serious, perhaps irrevocable, mistake. It would increase the federal deficit by reducing tax revenues, with much of the benefits going to tax evaders and to residents of oil-rich countries that have not entered into tax treaties with the United States. To the extent that repeal would encourage inflows of foreign capital into the United States, it would increase the exchange rate on the already overvalued dollar, thereby exacerbating an already serious economic problem. It would turn the United States into a tax haven, a disreputable step that would undermine our ability to get cooperation from other jurisdictions to curtail already existing tax haven abuses. And it would destroy any reasonable hope for much needed reform of our system of taxing foreigners operating within our borders. For all these reasons, we urge the Subcommittees to reject S. 1557.

5. Although S. 1557 attempts to restrict the sale of withholding-exempt bonds to bona fide foreigners, it seems likely that American tax evaders would be able to avoid these restrictions and engage in purchases of withholding-exempt bearer bonds through foreign nominees in tax havens. S. 1557 may, therefore, increase opportunities for tax evasion by Americans as well as foreigners.

6. The Treasury Department has frequently testified about the value of using negotiated reductions in withholding taxes as a bargaining chip in treaty negotiations to obtain better information exchanges with foreign countries. *See, e.g.*, Statement of David Rosenbloom, International Tax Counsel, *Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means Concerning Offshore Tax Havens*, 272, 314-15 (April 1979).

STATEMENT OF FENTON J. BURKE, ESQ., DEWEY, BALLANTINE, BUSHBY, PALMER AND WOOD, NATIONAL FOREIGN TRADE COUNCIL, INC., WASHINGTON, D.C.

Mr. **Burke**. I am a member of the law firm of Dewey, Ballantine, Bushby, Palmer and Wood. I am testifying here today on behalf of the National Foreign Trade Council, which has as members over 600 organizations engaged in international trade, and in my capacity as a member of the Council's tax committee.

The Council strongly supports the basic proposal contained in Senate 1557 to repeal the 30-percent withholding tax on interest payments to foreigners for several reasons. Most of them have been alluded to already.

Senator **Chafee**. Why don't you address, if you can, the points raised by Mr. McIntyre.

Mr. **Burke**. I would be happy to do that.

On his point that it will bid up the dollar, I think that the representatives of the Securities Industry Association responded to that quite effectively.

One particular point, and that is that I think it is generally conceded that people borrow abroad to get a lower interest rate. Lower interest rates are going to add to the competitiveness of U.S. companies. When interest rates drop in this country, the economy starts to pick up. And I think by giving added access to the international markets that does result in lower interest rates, that you will see a benefit there. It may make them more competitive rather than less competitive.

He made the point that it will be an irrevocable mistake. We had an exemption of this type back under the interest-equalization tax. It wasn't permanent, it wasn't indefinite, it was repealed. I think if it turns out that this doesn't work out the way people thought it would, it's not permanent, it's not indefinite. It wasn't before, and it won't be now.

The point about cheaters. That is something that I take strong exception to. First, there are many institutional organizations outside this country that are tax-exempt in their local jurisdictions and that do not have the benefit of a tax treaty that exempts them from the U.S. withholding tax, and where any tax, the U.S. withholding tax or other tax, is going to be an added cost to them.

Take a U.S. pension fund that wanted to buy obligations of a Swiss company. There would be a Swiss tax. Why should the pension fund incur that tax? It doesn't pay any tax here; it would simply be an added cost.

If you have other investors, investors that are subject to tax, they may not be in a position to get a complete foreign tax credit in their home jurisdiction. Again, the U.S. withholding tax is going to be an added cost to them. They are not going to want to bear it; they can go elsewhere.

The point about capital flowing in and out, and sudden surges—I think that rather than aggravating that, S. 1557 will ameliorate it, because we are basically talking about adding to the exceptions we now have in the statute for short-term money, the exception for interest paid on bank deposits and the exception for original-issue discount on obligations for 6 months or less. We are now talking about providing a sensible foundation for medium- and long-term borrowings. And rather than encouraging the short-term flow of funds in and out, I think we are going to encourage the flow of medium- and long-term funds and that is going to add to the stability of the market rather than detract from it.

If there are any other points that he made which you would like me to respond to, I would be happy to do so.

Senator CHAFEE. No, I think you have covered them. If there are others, I will note them. Does that complete your statement?

Mr. BURKE. Well, I would like to make one comment, and that is that I think that the 30-percent withholding tax is so riddled by exceptions, statutory and treaty, that it has turned into a discriminatory tax; it discriminates against those U.S. borrowers who are unable or unwilling to use the structures that others are using to obtain an exemption.

In addition, I think the tax is largely ineffectual. It's about as effective in raising revenue today as the Volstead Act was in curbing alcoholic consumption. I think this bill is a very sound bill.

Senator CHAFEE. All right, thank you.

Mr. Franasiak?

[Mr. Burke's prepared statement follows:]

September 19, 1983

SUMMARY OF STATEMENT OF
FENTON J. BURKE
PARTNER, DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD
ON BEHALF OF THE
NATIONAL FOREIGN TRADE COUNCIL, INC.
ON S. 1557
BEFORE THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

Good afternoon, my name is Fenton J. Burke. I am a member of the law firm of Dewey, Ballantine, Bushby, Palmer & Wood. I am testifying today on behalf of the National Foreign Trade Council and in my capacity as a member of the National Foreign Trade Council Tax Committee. The NFTC strongly supports the basic proposal embodied in S. 1557 to repeal the 30% withholding tax on certain interest payments to nonresident aliens and foreign corporations. As a matter of tax policy, the proposal has the added advantage of rationalizing the treatment of interest paid to foreigners.

Access to Capital Markets

The eurobond market is a very sizeable market which has become of increasing importance to U.S. business. U.S. companies have borrowed in this market because they have been able to obtain better rates and better terms than could be obtained domestically. The enactment of S. 1557 will enable U.S. companies to borrow in the eurobond market directly, thereby enabling them to avoid in many cases the limitations of the finance subsidiary method of financing and thereby improving their access to the eurobond market.

Tax Policy

The net effect of statutory and treaty exceptions to the 30% withholding tax on interest payments to foreigners has been to seriously compromise the effectiveness of the 30% withholding tax and to convert it into a discriminatory tax. Its burden, or more accurately its deterrent effect, falls only upon those U.S. borrowers who are unable or unwilling to structure their borrowings so as to avail themselves of an exception to the tax. S. 1557 would largely eliminate this discriminatory effect, a sound result from the standpoint of tax policy.

Technical Comments

Although S. 1557 would appear to permit U.S. companies to assume the existing indebtedness of their finance subsidiaries in most cases, some companies may be unwilling to effect such an assumption.

Interest paid to a controlled foreign corporation remains subject to U.S. income tax. According an exemption to foreign corporations generally and denying it with respect to foreign corporations controlled by U.S. stockholders seems anomalous and counterproductive.

Section 898 provides for the removal of the tax exemption where the exchange of information by a foreign country is inadequate to prevent evasion of U.S. income taxes by U.S. persons. It would seem desirable to have some indication as to whether it will apply only to the exchange of information with respect to interest income as well as some indication as to what will be regarded as adequate information with respect to interest paid on bearer obligations.

STATEMENT OF

FENTON J. BURKE

PARTNER, DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

ON BEHALF OF THE

NATIONAL FOREIGN TRADE COUNCIL, INC.

ON S. 1557

BEFORE THE

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

September 19, 1983

Good afternoon, my name is Fenton J. Burke. I am a member of the law firm of Dewey, Ballantine, Bushby, Palmer & Wood. I am testifying today on behalf of the National Foreign Trade Council and in my capacity as a member of the National Foreign Trade Council Tax Committee. The National Foreign Trade Council represents more than 600 companies engaged in international trade.

The NFTC strongly supports the basic proposal embodied in S. 1557 to repeal the 30% withholding tax on certain interest payments to nonresident aliens and foreign corporations. The adoption of this proposal will improve and expand the access of U.S. borrowers to capital markets outside the United States. As a matter of tax policy, the proposal has the added advantage of rationalizing the treatment of interest paid to foreigners.

Access to Capital Markets

The so-called eurobond market is a very sizeable market which has become of increasing importance to U.S. business. U.S. companies have borrowed in this market because they have been able to obtain better rates and better terms than could be obtained domestically. Both this administration and the prior administration have recognized that access to this market is an important element in the process of capital formation in this country. See letter dated May 23, 1983 from John E. Chapoton, Assistant Secretary (Tax Policy), to the

Honorable Sam M. Gibbons and the Statement made by Donald C. Lubick, then Assistant Secretary (Tax Policy), to a Subcommittee of the House of Representatives Committee on Ways and Means, as reported in the Daily Report for Executives, dated June 19, 1980.

There is no question but that the imposition of a 30% withholding tax on interest payments to foreign lenders would seriously curtail medium and long-term foreign borrowings by U.S. companies. Many foreign lenders are unwilling to suffer the imposition of such a tax and for perfectly understandable reasons. For example, there are foreign institutional investors who are exempt from taxation in the foreign countries in which they are located. They may be governmental or quasi-governmental entities or international organizations which do not qualify for the exemption from U.S. income tax under Section 892 of the Internal Revenue Code; they may be tax-exempt pension funds or philanthropic organizations. In addition, there are foreign investors who would be subject to tax on U.S. source interest in the foreign countries in which they are located, but who for a variety of reasons would be unable to obtain an effective tax credit in their home jurisdiction for a 30% U.S. withholding tax imposed on such interest. In these cases, a 30% U.S. withholding tax would constitute a very substantial out-of-pocket cost which the foreign investors would be unwilling to bear, particularly since they can avoid it either by investing their funds elsewhere or by investing their funds in the United States in bank certificates of deposit or short-term discount obligations.

As is well known, the existence of the 30% U.S. withholding tax on interest payments by U.S. companies has not precluded medium and long-term foreign borrowings by U.S. companies. Many U.S. companies have simply used finance subsidiaries to make such borrowings. There has been a considerable variety of such subsidiaries: Luxembourg, Netherlands, Netherlands Antilles, United States and other. The finance subsidiary method of financing, however, is not without its limitations, and some U.S. companies have been unable or unwilling to employ this form of financing. This unwillingness may, as has happened, be attributable to a U.S. company having a net operating loss which will prevent it from obtaining an effective foreign tax credit for any foreign income taxes imposed on the income of a foreign finance subsidiary, thereby increasing the cost of the financing to an unacceptable level. It may be attributable to the fact that the finance subsidiary method of financing is by its nature more involved than a direct borrowing by a U.S. company, particularly in the case of a financing by a U.S. company without any foreign operations. The enactment of S. 1557 will enable U.S. companies to borrow in the eurobond market directly, thereby enabling them to avoid in many cases the limitations of the finance subsidiary method of financing and thereby improving their access to the eurobond market.

Tax Policy

Although the United States imposes in form a 30% withholding tax on interest paid to nonresident aliens and foreign corporations, the imposition of this tax is, as suggested above, riddled by exceptions. These exceptions have undermined the effectiveness of the tax and have imparted to it a discriminatory effect. The exceptions are numerous and extensive. Pursuant to the Internal Revenue Code, interest paid on bank deposits is generally exempt from U.S. withholding tax as is original issue discount attributable to non-interest bearing obligations with an original maturity of 6 months or less; interest paid by a so-called 80-20 company, a U.S. company 80 percent or more of whose income is from non-U.S. sources, is exempt from U.S. withholding tax as is interest paid to foreign governments and certain international organizations. Pursuant to income tax treaties entered into by the United States, portfolio interest paid to residents of over 15 countries is generally exempt from U.S. withholding tax. By virtue of these statutory and treaty exceptions, U.S. corporations have been able to establish the finance subsidiaries mentioned above which have been able to borrow from, and more importantly pay interest free of U.S. withholding tax to, nonresident aliens and foreign corporations.

The net effect of all these exceptions to the 30% withholding tax on interest payments to foreigners, particularly given the widespread use of finance subsidiaries, has been to seriously compromise the effectiveness of the 30% withholding tax and to convert it into a discriminatory tax. Its burden, or more accurately its deterrent effect, falls only upon those U.S. borrowers who are unable or unwilling to structure their borrowings so as to avail themselves of an exception to the tax. S. 1557 would largely eliminate this discriminatory effect, a sound result from the standpoint of tax policy.

Technical Comments

1. Proposed Section 871(a)(4)(A). Although S. 1557 would appear to permit U.S. companies to assume the existing indebtedness of their finance subsidiaries in most cases, some companies may be unwilling to effect such an assumption. Some U.S. parent companies may be unwilling to liquidate their finance subsidiaries because, for example, the subsidiaries are engaged in other business activities. Further, a U.S. parent company may be reluctant to effect a separate assumption of a finance subsidiary's debt because of questions concerning the tax treatment of the assumption itself. These questions could probably be avoided by providing that the U.S. company assuming the finance subsidiary's debt would succeed to any tax attributes associated with that debt, such as original issue discount. Further, some finance subsidiaries

have issued bonds or notes with warrants which entitle the holder thereof to purchase additional debt obligations of the finance subsidiary in the future. In the event a U.S. parent company assumes the warrant obligation and the warrant is exercised, it may be argued that interest paid on obligations issued pursuant to the exercise of the warrant would not be exempt from U.S. income tax either under Section 871(a)(4)(A) because the debt obligation was not issued prior to the date of enactment of S. 1557 or under Section 871(a)(4)(B) because it did not comply with the requirements of Section 163(f)(2)(B).

2. Proposed Section 881(c). Subject to various exceptions, this section generally exempts interest paid to foreign corporations from U.S. income tax. Interest paid to a controlled foreign corporation (a phrase which technically needs to be defined) is one exception; it remains subject to U.S. income tax. According an exemption to foreign corporations generally and denying it with respect to foreign corporations controlled by U.S. stockholders seems anomalous. This anomaly is accentuated by the fact that the imposition of a U.S. income tax on interest paid to a controlled foreign corporation may result in double taxation since a U.S. corporate stockholder of the controlled foreign corporation cannot claim a foreign tax credit for a U.S. income tax. What purpose is served by discouraging a controlled foreign corporation from investing its

funds inside the United States when the object of the bill is to promote access by U.S. borrowers to international capital markets? A somewhat similar impediment to U.S. investments by controlled foreign corporations existed under Section 956 of the Internal Revenue Code, and Section 956 was amended to eliminate the impediment. See Section 956(b)(2)(F). The explanation of this amendment by the Staff of the Joint Committee on Taxation states that:

> "In its prior form [Section 956] may, in fact, have had a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a controlled foreign corporation looking for a temporary investment for its working capital was, by this provision, induced to purchase foreign rather than U.S. obligations." Staff of the Joint Committee on Taxation, 94th Cong., 2d. Sess., General Explanation of the Tax Reform Act of 1976, p. 228.

The treatment in proposed Section 881(c) of interest paid to controlled foreign corporations is likely to have a similar detrimental effect.

3. Proposed Section 898. This section provides that the proposed exemptions from U.S. income tax will not apply to payments of interest "addressed to or for the account of persons" within a foreign country when the Secretary has determined that the exchange of information between the U.S. and the foreign country is inadequate to prevent evasion of United States income tax by United States persons. Since the scope of the proposed exemptions from U.S. income tax provided by S. 1557 may be substantially affected by this provision, it would seem desirable to have some indication as to whether Section 898 applies only to the exchange of information with respect to interest income as well as some indication as to what will be regarded as adequate information with respect to interest paid on bearer obligations.

STATEMENT OF DAVID E. FRANASIAK, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE, WASHINGTON, D.C.

Mr. **Franasiak.** I am David Franasiak, manager of the tax policy center at the U.S. Chamber of Commerce, and I am accompanied today by Rachelle Bernstein, senior tax attorney for the chamber. We welcome this opportunity to present our views on S. 1557.

I would like to build on what the other witnesses just said and also reemphasize some of the policy reasons why we think that this bill should be enacted.

We face a shortage of capital in this country, and the elimination of withholding will help encourage greater foreign investment in the United States.

I think it is important to note that the inherent strength and stability of this country is one of the prime reasons why foreigners wish to invest in the United States. The growth in economic strength of the European Community and Japan, however, has made investment in their industries increasingly attractive as well.

American industry will be placed at a competitive disadvantage if foreign issuers may borrow in the Eurodollar market without withholding tax and U.S. companies cannot. Funds would be attracted to foreign companies that might otherwise have gone to purchase American securities.

The removal of the tax on interest paid to foreign investors also will help to ease credit problems for U.S. home buyers, farmers, and small businesses. While these small borrowers generally will not be able to attract foreign investment funds, they presently compete with major corporations for the dollars available for domestic investments by allowing U.S. businesses to sell their debt instruments in foreign markets more easily, the amount large firms need from domestic markets will be reduced. This in turn will allow more money to be made available to smaller borrowers.

I think just to comment and build on some of the comments that the gentleman before me had on Mr. McIntyre's statement: I think Mr. McIntyre doth protest too much. He is very much concerned, I think as we all are, about the influx in imported goods into our country, as well as our deteriorating trade balance picture. And I think to just simply point to this particular bill as being something which will unleash the floodgates and which will cause us to lose even more of a competitive edge is rather disingenuous. Indeed, when you look at our export situation, the cost of labor has as great an impact on a loss of competitive position as just about anything else.

Last, he did bring up this important point of trade balance, and I think we need to focus on that in all legislation we look at from here on out.

In closing, I also particularly want to thank you, Senator Chafee, for your efforts in bringing this bill forward to this committee and to the Senate.

Thank you.

Senator **Chafee.** Well, thank you very much, Mr. Franasiak.

Mr. Hannes?

[Mr. Franasiak's prepared statement follows:]

STATEMENT
on
FOUR PENSION AND TAX PROPOSALS
before the
SUBCOMMITTEES ON SAVINGS, PENSIONS, AND INVESTMENT POLICY
and
TAXATION AND DEBT MANAGEMENT
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
David E. Franasiak
September 19, 1983

I am David E. Franasiak, Manager of the Tax Policy Center at the U.S. Chamber of Commerce. I am accompanied today by Rachelle B. Bernstein, Senior Tax Attorney for the Chamber. We welcome the opportunity to present the Chamber's views on S. 1557, S. 1550, S. 1666, and S. 1066.

S. 1557

The Chamber strongly supports removing the withholding tax on interest paid to foreign portfolio investors. The United States faces a critical shortage of capital. Decreasing levels of investment in American industry have contributed substantially to the decline in our productivity. The elimination of the 30 percent tax on interest paid to foreign portfolio investors could help to ease this situation by encouraging greater foreign investment in the United States.

Present Law

The taxes imposed on interest paid to foreign investors vary with the nature of the interest and the circumstances of the foreign recipient. If interest is paid to a foreign investor as a result of ongoing business activities in the United States, it is included with the other income and expenses of the business and taxed at the standard corporate or individual rates.

Interest received by a foreign investor from passive investment in the U.S. generally is subject to tax at a flat rate of 30 percent (or less under some treaties) on the gross amount paid. The tax is collected by the person paying the interest, through withholding 30 percent from the full amount to be paid.

In order for U.S. borrowers to compete for foreign investment capital, they must either issue obligations the interest on which is not subject to tax in the U.S. or pay higher interest rates. This is because these obligations primarily compete with debt securities sold in the Eurobond market which are free of taxes withheld by the country of issuance. As a practical matter, raising interest rates to compensate for the 30 percent tax imposed by the U.S. makes the cost of foreign capital too expensive. However, U.S. corporations can presently borrow through the Eurobond market by establishing financing subsidiaries in countries which have a tax treaty with the United States providing for an exemption from U.S. tax for U.S. source interest paid to foreign persons. Almost all of these financing subsidiaries are located in the Netherlands Antilles. (The U.S. Treasury Department has been in the process of renegotiating the U.S./Netherlands Antilles tax treaty for more than two and one-half years.)

Need for Additional Capital

American business faces a severe capital shortage. The heavy demands for capital and the limited supply of funds available have caused interest rates to rise to unprecedented levels in past years and remain at rates which severely restrict the ability of businesses to borrow funds needed for corporate expansion. Removing the withholding tax on interest paid to foreign portfolio investors will allow American business freer access to international markets and, thus, increase the amount of funds available for borrowing.

The inherent strength and stability of this nation is one of the prime reasons that foreigners wish to invest in the United States. The growth in the economic strength of the European Community and Japan, however, has made investment in their industries increasingly attractive.

Many countries have helped their industries to increase their share of international investment by eliminating taxes on interest paid to international investors in some way. Among those countries which have allowed issuers to borrow in the Eurobond market without taxing interest at the source are:

> Algeria, Argentina, Australia, Austria, Brazil, Belgium, Canada, Chile, Colombia, Costa Rica, Denmark, Finland, France, Greece, Hungary, Iceland, India, Indonesia, Israel, Iran, Ireland, Italy, Japan, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Papua New Guinea, Philippines, Portugal, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Trinidad & Tobago, Thailand, United Kingdom, Venezuela, West Germany, Yugoslavia.

American industry will be placed at a competitive disadvantage if foreign issuers may borrow on the Eurodollar market without withholding tax and U.S. companies cannot. Funds would be attracted to foreign companies that might otherwise have gone to purchase American securities.

The removal of the tax on interest paid to foreign investors also will help to ease credit problems for U.S. home buyers, farmers, and small businesses. While these small borrowers generally will not be able to attract foreign investment funds, they presently compete with major corporations for the dollars available for domestic investment. By allowing U.S. businesses to sell their debt instruments in foreign markets more easily, the amount large firms need from domestic markets will be reduced. This in turn will allow more money to be made available to smaller borrowers.

Repeal of Withholding Tax Provides Best Access to International Capital Markets

Although U.S. borrowers can presently gain access to international capital markets through the use of financing subsidiaries in countries like the Netherlands Antilles, such devices do not provide optimum access to international capital markets. Presently, a number of prospective U.S. borrowers are reluctant to utilize financing subsidiaries in the Netherlands Antilles because the uncertainty arising from the present treaty negotiations has caused a fear that changes in or termination of that treaty may result in the prepayment of overseas issuances. Repeal of the withholding tax would allow access to the Eurobond market by U.S. businesses which have heretofore avoided this source of capital because of the complicated procedures involved in establishing a Netherlands Antilles subsidiary. Finally, investments made in the U.S. may be more attractive to foreign lenders because commissions on securities transactions are generally lower in the United States.

Repeal of Withholding Raises Revenue

In addition to providing more desperately needed capital to U.S. businesses and potentially lowering interest rates because more capital is available, repeal of the 30 percent withholding tax would raise revenues to the U.S. Treasury. The U.S. Treasury Department has estimated that repeal would result in a $35-50 million revenue gain per year. Furthermore, the increased capital investment in the United States will increase employment in the U.S. and, thus, increase federal revenues.

S. 1666, The Capital Formation Tax Act of 1983

Although the Chamber has not taken a position on this bill, we do have several comments which relate to the bill's construction as well as to several important tax policy issues raised by the bill.

The bill increases the section 1202 deduction for net capital gain from 60 to 80 percent if the stock: 1) is purchased through an initial stock offering, 2) is purchased from the initial offerer, underwriter, broker or agent, 3) represents contributions to capital or paid-in surplus of the corporation, and 4) is held for five years.

The policy behind the bill as expressed by several of the cosponsors on introduction of the bill was to make the stock of start-up ventures, other small business firms and high technology companies more attractive to investors. As presently drafted, it is not clear that the bill will accomplish these goals.

In order to qualify, the investor must purchase stock which is "publically or privately offered through an initial stock offering of any corporation." This is a very broad requirement which could be easily satisfied. For example, the issuance of a new class of stock by a major corporation would might be construed to meet the requirement as would a new class of stock issued by a large privately held corporation. There is no requirement that the stock be issued by an operating company. It is unclear whether the stock must be an initial offering (stock issued when the corporation is formed) or whether the initial offering of a corporation which is a successor to an older corporation would be considered an initial offering.

Tax Policy Issues

We believe the lowering of capital gains rates across the board is desirable. The 1978 capital gains tax reduction was the first in a series of tax changes which promoted savings and investment. Since 1978 there is considerable evidence of the beneficial economic effects of reductions in taxes on capital gains. The performance of the equity markets has improved dramatically and new capital raised through initial public stock offerings has broken new records. Moreover, taxes paid on capital gains increased from $9.3 billion in 1978 to $11.5 billion in 1979, to $12.2 billion in 1980 and $11.6 billion in 1981.

However, S. 1666 does not provide across the board reductions in the capital gains rates. Instead it reduces the rate on certain qualified stock which is purchased and held for more than five years from the maximum of 20 percent to a maximum 10 percent. We believe that it is inadvisable to create a capital gains tax regime which has multiple rates and holding periods. Such a regime would create many technical problems, increase the complexity of the tax code and encourage litigation. Between 1934 and 1942, the tax law contained multiple rates and holding periods. Under that regime, which applied to all taxpayers, a certain percentage of realized capital gains was excluded from ordinary income. The amount excluded during the years from depended on the period for which the asset had been held. For example, the table below reflects the tax regime in effect between 1934 and 1937: :

Percentage of Capital Gains Included in Ordinary Income	Holding Period
100%	less than one year
80%	1 - 2
60%	2 - 5
40%	5 - 10
30%	more than ten years

Because of the marginal income tax rates were more than doubled (in come cases almost tripled) in the early thirties, capital gains tax considerations became of extreme importance to an investor's decision whether to realize his gains -- especially to those taxpayers in higher ordinary income tax brackets.

The substantial tax cost to realizing shorter term capital gains caused many taxpayers to defer realization in order to take advantage of the lower rates associated with the longer holding periods. This reduced the efficiency and productivity of the economy by impeding the flow of capital resources into the sectors of the economy where it was most needed.

In 1938, Congress reduced the number of holding periods from five to three, and in 1942 totally eliminated the multiple holding periods of 1934-41, because they constituted unacceptable impediments to capital flows. When examining the provisions of S. 1666 which create long holding periods as a condition of favorable tax treatment, Congress should consider the judgment of the Congress of 1938 and 1942 that similar provisions constituted unacceptable impediments to capital flows.

Technical Issues

There are numerous problems which arise under present law in determining the holding period of an asset. These problems can be resolved much more easily, however, where the holding period is short, i.e. six months or one year, than where longer holding periods, i.e. five years, or multiple holding periods and multiple rates are involved. For example, in many smaller firms it is difficult to determine when a security is issued or when it is actually acquired. The Tax Court has held that, in the absence of a statutory or charter provision, a suscriber for stock in a corporation becomes a stockholder when his subscription is accepted, whether or not a certificate is issued to him. However, if the subscription is not binding, the holding period won't commence until it is.

Problems also arise where a taxpayer enters into a tax-free exchange of property. A taxpayer's holding period for a security received in an exchange includes his holding period for the asset he had to give up.

Where securities are acquired by the exercise of an option or warrant issued to an employee or any other person, the courts are divided as to whether the acquisition date is the date the holder of the option or warrant acquires actual ownership rights in the securities in accordance with the option or warrant agreement or the date he acquires substantial contract rights in the securities which will ripen into full membership.

The Chamber strongly supports an overall reduction of the capital gains rate; however, we urge this Committee to consider carefully the potential impediments to capital flow and complications which may arise from creating a multiple rate- multiple holding period system.

S. 1550

This bill was designed to relieve international double taxation of overseas construction projects of U.S. contractors. The Chamber is still studying this bill and, therefore, cannot present a position on it today. However, we are strongly opposed to international double taxation. To the extent U.S. industry is subject to double taxation it is placed at a competitive disadvantage in relation to foreign industry. Moreover, double taxation is so onerous that where it exists it would be likely to produce a contraction of U.S. business overseas. To the extent that any segment of U.S. industry is subject to international double taxation, we believe some relief is needed.

S. 1066

This bill is designed to amend the Employee Retirement Income Security Act (ERISA) to allow employers and employees jointly to purchase an insured annuity contract at the time of an employee's retirement in order to fund a retirement benefit that would supplement benefits available to the employee under a tax-qualified defined benefit plan. The Chamber is presently studying this bill and would be happy to work on it with the Committee in the future.

STATEMENT OF STEVEN P. HANNES, CHAIRMAN, INTERNATIONAL TAX SPECIALTY GROUP, TOUCHE ROSS & CO., WASHINGTON, D.C.

Mr. **Hannes**. My name is Steven Hannes, and I am the chairman of the International Tax Specialty Group of Touche Ross & Co. I very much appreciate this opportunity to testify today on behalf of S. 1557. Indeed, I believe S. 1557 does have a number of important virtues, as has been stated before today. A number of these virtues have been explained before. Therefore, I will not go into any great detail.

The legislation is clearly a practical means of attracting important foreign investments to the United States. It would simplify, I think appropriately, existing patterns of investment.

I think it is important to note that other countries are very much aware of the importance of the Eurobond market. The United Kingdom, in 1983, proposed legislation which would have made access to that market easier for United Kingdom companies. It is my understanding that the United Kingdom will shortly reintroduce legislation going in the same direction as S. 1557.

Importantly, I think the legislation would eliminate for the future current audit uncertainties with respect to the offshore financing vehicle. It has been pointed out that there is a revenue savings to the U.S. Treasury. This saving is of some interest at a time of significant revenue deficits.

Finally, I think the resolution of this issue by Congress will help accelerate the Netherlands Antilles negotiations and hopefully eliminate some of the uncertainties that currently exist with respect to the ability of residents of third countries to use that treaty in the future.

With respect to one point that was raised before by Mr. McIntyre and has been responded to in part by Mr. Burke, I would like to say that I fully agree that a large number of foreign investors would find that this legislation provides an attractive vehicle for investment into the United States. But, those investors will not necessarily be evading tax in the country in which they reside. That is to say, their countries will not necessarily impose tax on this income—and therefore, their investment in the United States may be entirely "appropriate."

One interesting ramification of this legislation is that, to the extent that there is currently any evasion of U.S. tax by U.S. persons investing in Euirodollar bonds—and that is a highly speculative matter—this legislation would actually make it easier for the Internal Revenue Service to obtain information which would assure that any such practice stops.

So, in short, I would like to heartily endorse this legislation and encourage you to move on it as promptly as possible.

Senator **Chafee**. Thank you very much, Mr. Hannes.

[Mr. Hannes' prepared statement follows:]

Touche Ross & Co.

Senate Finance Committee

Subcommittee on Savings, Pensions and Investment Policy

Subcommittee on Taxation and Debt Management

Hearing on S.1557

Statement by Steven P. Hannes

Chairman, International Tax Specialty Group

Touche Ross & Co.

September 19, 1983

Mr. Chairman and members of this distinguished Committee:

My name is Steven P. Hannes and I am the Chairman of the International Tax Specialty Group of the international public accounting and tax consulting firm of Touche Ross & Co. I appreciate the opportunity today to put before you the views of Touche Ross & Co. supporting S.1557, which would amend the Internal Revenue Code of 1954 (the Code) to exempt from U.S. income tax interest paid to certain nonresidents on three types of debt instruments, frequently called Eurodollar or Eurobond offerings. Legislation such as S.1557 is extremely important to the U.S. tax system and should be enacted as expeditiously as possible.

The tax exemption provided by this bill to certain nonresident aliens and foreign corporations would create the following benefits:

(1) It would offer United States borrowers a practical means of attracting certain types of foreign investment;

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(2) It would remove the current incentive to use so-called "offshore finance subsidiaries" to borrow overseas, thereby eliminating future disputes between the I.R.S., U.S. taxpayers and treaty partners;

(3) It would generate a revenue saving to the United States Treasury;

(4) It would offer an opportunity to improve certain aspects of the U.S. income tax treaty program and thereby could restore, to a considerable extent, the ability of the U.S. Government to determine whether residents of various foreign countries will receive certain U.S. income tax benefits.

The Eurodollar market has frequently proven to be an attractive and important source of capital for the United States. Even the U.S. Government has been attracted to this market. For example, the Federal National Mortgage Association recently explored with Treasury the possibility of Eurodollar financing as a source of funds for housing. While estimates vary greatly on the amount of capital that the Eurodollar market has contributed to U.S. companies -- primarily through debt currently issued by offshore finance subsidiaries -- by any standard the amount is significant. Particularly in a period of U.S. economic recovery, it is very appealing to have this large and expanding market readily available to the United States as a source for capital.

The importance of assuring tax-free access to the Eurodollar or Eurobond market has not been lost on other countries. For example, the United Kingdom will probably enact in 1984 legislation which would assure that United Kingdom entities could obtain certain types of offshore financing without suffering the cost of the United Kingdom 30 percent withholding tax on interest. Other countries, such as the Netherlands, guarantee tax-free access by way of a broad exemption for interest paid to nonresidents. Thus, legislation such as S.1557 would conform the U.S. tax treatment of interest on Eurodollar bonds to the tax treatment provided similar interest by certain other developed countries.

Although we believe that S.1557 will achieve its intended objectives, it is not possible at this time to be certain on this point because some aspects of S.1557 are tied to another Code section, 163. That is, two of the three categories of debt instruments covered by S.1557 must meet requirements imposed by Code Section 163(f)(2)(B). On September 1, 1983, the Internal Revenue Service issued proposed regulations under these provisions of Section 163. Only when these proposed regulations are thoroughly analyzed and then finalized will it be possible to be certain whether S.1557 will in fact achieve its intended objectives.

A preliminary reaction to the proposed regulations under Section 163(f) is, however, that they appear workable and should not interfere with the ultimate goals of S.1557. In their application to one provision of S.1557, they do suggest a comment. One purpose of S.1557 is to encourage repatriation of a targeted class of Eurodollar loans, presently outstanding through offshore financing subsidiaries. This is expressed in proposed Sections 871(a)(4)(A) and 881(c)(1). Not only does the Government want these loans repatriated, but many United States corporations would like to close down offshore arrangements. It would be unfortunate if technical failures to fall within the requirements of Section 163(f)(2), or the Regulations which are ultimately adopted, precluded this. Such a result might be avoided if the Secretary were given authority, either in his discretion or by regulation, to include in the group covered by proposed Section 871(a)(4)(A) and 881(c)(1) other Eurobond issues which are substantially similar to those covered by Section 163(f)(2)(B)(i) or the proposed regulations.

The paragraphs that follow elaborate on our basic observations on S.1557.

In a practical sense, U.S. companies find the Eurodollar market attractive, not only because it presents an additional source of capital but also because the cost of borrowing that capital is frequently lower than it would be in the United States. That is, interest rates on Eurodollar offerings are frequently lower than on U.S. financing. Also, issuing costs can be significantly lower than domestic issuing costs. This cost saving would usually be nullified if a U.S. company issued debt directly to a foreign person. In the usual situation, Section 871(a) or 881(a) of the Code would impose a 30 percent federal income tax on the gross amount of the interest paid by a U.S. company to a foreign lender. In the case of Eurodollar offerings, this income tax burden would probably be borne economically by the U.S. borrower because lenders customarily insist that interest paid on the Eurobond issue be "grossed-up" to include any such withholding tax. The resulting interest rate would be uneconomically high; this has led to the use of borrowing arrangements designed to avoid withholding taxes.

For some years, U.S. companies have legally avoided the 30 percent U.S. tax on Eurodollar interest by using the following arrangements:

(1) A U.S. company would invest the borrowed funds outside of the United States under arrangements designed to prevent the interest paid from being U.S.-sourced; or

(2) A foreign affiliate -- offshore financing subsidiary -- would borrow in the Eurodollar market and relend to its U.S. affiliates.

The second type of financing, as described below, has been facilitated by U.S. income tax treaties. In both types of financing arrangements the U.S. parent company typically assures the commercial viability of the debt offering by guaranteeing the debt of its subsidiary.

S.1557 would allow U.S. companies (and the U.S. Government) to achieve the U.S. tax savings currently allowed in the foreign affiliate arrangement, but would eliminate the need for an offshore finance subsidiary. Thus, U.S. companies could reach the Eurodollar market directly and obtain the same (or perhaps greater) economic saving enjoyed now. In this sense, S.1557 would appropriately simplify the existing Eurodollar financing mechanism.

One advantage of this simplification is that it should eliminate, for the future, contentious U.S. tax issues currently facing those who have employed offshore financing vehicles to reach the Eurodollar market. These issues involve whether the offshore finance subsidiary or its U.S. parent is the true "obligor" of the Eurodollar offering, or whether the interest expense shown on the books and records of the offshore finance subsidiary is more properly viewed, for U.S. income tax purposes, as interest paid directly to the foreign lender by the U.S. parent company. Under current law, if the debt is considered to be that of the U.S. parent rather than of its foreign affiliate, or if the interest is considered paid to the foreign lender by the U.S. parent rather than by its foreign subsidiary, there would normally be a 30 percent U.S. tax imposed on that interest under Code Section 871(a) or 881. Legislation such as S.1557 can eliminate these disputes for the future by rendering unnecessary the use of financing arrangements which generate them.

A further important consideration for the Congress is the revenue effect of the proposed legislation. The offshore financing subsidiaries mentioned above are liable for income taxes in the jurisdictions in which they are resident. While these foreign income taxes may be small in amount relative to the 30 percent U.S. tax that is saved by using the offshore finance subsidiary, they are not inconsequential, and produce a revenue cost to the U.S. Treasury, which comes about through the operation of the U.S. foreign tax credit. That is, if the taxable income of the offshore financing subsidiary is included in the U.S. parent's income under subpart F of the Code, or by way of an actual dividend distribution, the parent receives a corresponding tax credit for the taxes paid to the foreign country. In both situations, the "deemed-paid" foreign tax credit offsets the foreign income taxes, dollar-for-dollar, against any U.S. income tax that would otherwise be imposed on the repatriated profits of the offshore finance subsidiary. To the extent that S.1557 makes it unnecessary to use offshore finance subsidiaries, it will produce a gain to the U.S. Treasury by way of a reduction in foreign tax credits claimed. This revenue saving should be of particular interest now, when revenue deficits are of great concern.

As mentioned above, income tax treaties play a role in current arrangements involving offshore finance subsidiaries. The Income Tax Convention between the United States and the Netherlands, as extended to the Netherlands Antilles (Netherlands Antilles Convention), has been used frequently for Eurodollar offerings. It has two provisions which, taken together, make it particularly attractive. The first is an exemption from United States withholding tax on interest paid to an Antilles corporation which is not engaged in a trade or business through a U.S. permanent establishment. Thus, if creation of a permanent establishment can be avoided, there is usually no U.S. tax on interest paid to the Antilles entity. (If for some reason the Antilles entity is found to have a U.S. permanent establishment, then its business profits are subject to U.S. tax on a net basis, subtracting the interest paid to foreign investors from the interest received from the U.S. affiliate. The resulting net income is very small.)

The second advantage of the Netherlands Antilles Convention is the assurance that the offshore finance subsidiary can pay interest to its lenders free of the 30 percent U.S. withholding tax, even if the subsidiary is considered to be earning income effectively connected with the conduct of a trade or business in the United States. Absent a treaty, the Code treats interest paid by a foreign corporation which is engaged in trade or business in the United States as being from United States sources, if 50 percent or more of the gross income of the company is effectively connected with the conduct of the trade or business in the United States. If that happens, some or all of the interest paid by the company would be subject to the 30 percent U.S. tax. Under the Netherlands Antilles Convention, however, the 30 percent withholding tax is not imposed on interest paid by the Antilles company whether or not its operations in the United States constitute a trade or business. Importantly, the exemption in the Convention applies regardless of where the recipient of the interest resides. Thus, a resident of any country can legally avoid the 30 percent U.S. tax that might otherwise apply on Eurodollar interest by way of the Netherlands Antilles Convention.

This and other types of so-called "third country use" of U.S. tax treaties may have been accepted with few questions 20 years ago, but have been increasingly challenged as a matter of U.S. tax policy in recent years. See, for example, the Hearings before the House Governmental Operations Subcommittee on Commerce, Consumer and Monetary Affairs, on April 13, 1983, where this matter was considered in the context of the Netherlands Antilles Convention. It appears that, so long as the Netherlands Antilles remains the principal avenue for U.S. companies to reach the Eurodollar market, it may be very difficult for the United States Treasury to negotiate a new treaty with the Netherlands Antilles that would, from the perspective of the United States Government, appropriately limit the opportunities for residents of third countries to take advantage of U.S. tax savings through the Netherlands Antilles. If legislation such as S.1557 were enacted, U.S. companies would have an alternative route to the Eurodollar market. This would provide a better opportunity for Treasury to rationalize the current Netherlands Antilles Convention. Such a rationalization would have important implications to the U.S. tax treaty program and could restore, to a considerable extent, the ability of the United States Government to determine whether residents of various countries will receive certain U.S. tax benefits. Thus, in a number of respects, legislation such as S.1557 has important, and favorable, international tax policy implications.

We would like to make one brief comment on proposed Section 898, which denies the interest exclusion to residents of any foreign country, if the Secretary determines that information exchanged with that country is inadequate to prevent tax evasion. The objective of the section is reasonable -- to act as an incentive for foreign countries to provide necessary information and, if necessary, to negotiate agreements to do so -- but as presently worded it may present problems. Most foreign countries have laws protecting the secrecy of tax information, similar in effect to our own. In other words most countries can only give out tax information by way of an executive agreement, tax treaty or mutual assistance treaty. One could view any country which does not have such an agreement or treaty with the United States on the date of enactment of S.1557 as having an "inadequate exchange." Thus, under this interpretation, the section would have immediate consequences when the amendments in the bill take effect, without any provision for a period within which negotiations could take place. Moreover, the section is both mandatory in application once a determination is made and applicable to all interest paid to the country which is the subject of the determination. This may be a penalty so great that it never will be invoked. We recommend, therefore, that the Committee take steps to make clear that the Secretary has discretion in the application and in the scope of the section. This would assure the fairness of the section as well as give the section the maximum utility in tax administration.

In conclusion, we endorse the broad objective of S.1557 and encourage the Committee to move as expeditiously as possible to assure that Eurodollar offerings can be issued without the use of an offshore finance subsidiary and free of the 30 percent withholding tax. Such legislation would simplify current arrangements, avoid contentious issues on audit, produce revenue savings, and potentially restore a measure of U.S. control over certain U.S. tax benefits as well as assist in the rationalization of certain aspects of U.S. income tax treaties.

* * * * *

Senator **Chafee**. Now, Mr. McIntyre, I listened with interest to your comments. It seems to me we have a situation where large corporations can raise money by taking this circuitous route. And, as was stated by Mr. Rey or Mr. Evans, it is antismall business. The small firm finds it too expensive to take that route to raise money. This legislation would put all of them on an equal footing, give all equal access to foreign investment. What do you say to that?

Mr. **McIntyre**. Well, first of all, the idea of a small company floating corporate bonds is not something that is really going to happen. But in terms of the Netherlands Antilles, which you are talking about here, we have strongly advocated in our testimony that Treasury go forward with the process of cutting out that loophole. In fact we think it is a disgrace that the Antilles has become a pipeline for us to get money from foreign tax avoiders. And we support the efforts, which I assume are still ongoing at Treasury, to crack down on the Antilles Treaty. There is not an easy answer.

Senator **Chafee**. What you are seeking, in other words, is that all foreign borrowers pay 30 percent on their income from U.S. corporate securities that they hold.

Mr. **McIntyre**. Well, actually, no. What we are suggesting in our testimony is that there are two routes: One is to have a uniform 15-percent rate—30 is too high, in practice. A second, which would be equally acceptable, I think, is to continue the process of negotiating that rate down. If we want to continue to negotiate it down to zero that may be acceptable, but with disclosure requirements.

Let me point out, Mr. Chairman, that back in 1980 when the Finance Committee approved the bill repealing the withholding tax, it included very tough disclosure requirements, whereby foreigners, to be exempt, would have to basically let their governments know they were earning U.S. interest. When that bill got to the Ways and Means Committee, all of the supporters of the bill turned around and said, "Well, actually, with this disclosure requirement in the bill it doesn't do us any good. Take it out. None of the Europeans will buy our bonds if their governments are going to know about it." Now, that's the position, and I think it makes very clear who we are trying to sell these bonds to. We don't think that's acceptable U.S. tax policy.

Senator **Chafee**. Well, let's see if I understand it. You are saying that if we repeal the withholding, in order to qualify, Europeans would have to file with the corporation, General Motors or whoever it is, their full name and so forth. And then what would happen? We would forward that? If it is a United Kingdom citizen, we would forward that to the British Government?

Mr. **McIntyre**. That is roughly what happens under our negotiated treaty reductions in the withholding rate now. And we think that that system at least cuts down on international tax evasion, which is a very important thing for the United States to fight.

Senator **Chafee**. What do you say to that, Mr. Burke?

Mr. **Burke**. Well, two things. One, I think the passion for anonymity that may exist is not necessarily attributable to a desire to avoid taxes. I think the United States is a very open society and that other countries are more closed, and other companies elsewhere in the world operate with a great deal more secrecy. And as a result of that, you have had commercial practices develop outside this country that involve the use of bearer obligations simply because people don't want others to know what they are doing, without regard to what their tax situation is. And you have a commercial practice that now exists that is one that I think we have to compete with.

There are other countries—Canada is one; Canada provides an exemption from Canadian withholding tax for long-term borrowings outside Canada. The Netherlands has no withholding tax at all on interest payments. Germany has an exception with respect to the German withholding tax on interest payments. The Japanese have permitted their companies to borrow in this market. I think that you have to face up to the fact that we are in a competitive situation.

Senator **Chafee**. Well, Mr. McIntyre, that does trouble me. What we are trying to do here—and I'm sure you subscribe to it; you are representing the AFL-CIO, as I understand it—is attract more capital for our industries and indeed for our Government.

Mr. **McIntyre**. Well, actually, Mr. Chairman, in the short run that is exactly what we don't want to do, if you are worried about the auto industry, if you are worried about import-sensitive industries. Attracting more foreign capital, when foreigners buy our assets rather than buy our goods, is in the short run quite a big mistake.

In fact, our problem is that foreigners are too attracted to our assets and not attracted enough to our goods. And that is one of our problems.

Senator **Chafee**. I don't think these are mutually exclusive, though. I think that because somebody invests in your companies, it doesn't mean that they are not going to buy your automobiles, does it?

Mr. **McIntyre**. Well, that may be. But the reason that, in fact, the dollar has been pushed up, at least according to the President's economic advisers, and I think they are right, is because of the extraordinary current demand for U.S. financial assets and not for U.S. goods. It has been shifting in that direction, and eventually the market will smooth that out, as people say, "Eventually, interest rates will come down." I think that's right, but "eventually" is a ways away, and in the short run we are causing a great deal of job loss and personal dislocation for a lot of American workers. We think that is a bad idea.

Senator **Chafee**. And the way to help it is to keep a 30-percent withholding tax on?

Mr. **McIntyre**. Well, again, if the other members of the panel are correct that repeal will cause an influx in the net capital situation, then repeal will be harmful. If repeal does nothing but cost the Treasury $100 million a year, then we still think it is harmful because it also encourages tax evasion. But you can't have this one both ways. If it has an economic effect, it is going to be to reduce exports and to increase purchase of U.S. assets, which is the wrong direction to be going right now from an economic point of view.

I think, it's hard to prognosticate how big that effect will be. It may be small. But if it's there——

Senator **Chafee**. Do you mean that having a greater pool of capital available for the U.S. Government or for the total U.S. borrowers—it reduces interest rates, does it not?

Mr. **McIntyre**. Eventually it will, that's right. But you know, we are not talking about long-term bonds, in spite of the comments from the panel. There is no long-term market in Europe. We are talking about 1-year bonds.

Senator **Chafee**. Well, answer that, Mr. Burke.

Mr. **Burke**. Well, we are not talking about 1-year bonds; we are talking about obligations, generally, between 5 and 15 years.

Senator **Chafee**. Yes, that is quite clear.

Mr. **McIntyre**. Well, I take as my text here the Joint Committee on Taxation, which points out that there is no significant market for long-term bonds outside the United States, and that, having read testimony in the previous——

Senator **Chafee**. Well, they might be referring to because of this tax.

Mr. **McIntyre**. No, no, no.

Mr. **Burke**. I think they might be referring to 30-year debt or 25-year debt. But certainly in terms of the offerings that I am familiar with, they are generally for not less than 5 years and often for considerably longer. And with respect to the savings in interest costs, I think, in correspondence with the Treasury concerning this bill, there was an indication that one U.S. company was able to borrow abroad at a rate less than the rate then applicable to U.S. Government securities of comparable maturity. And you can imagine what the saving would be to the U.S. Government under those circumstances if it could have borrowed at that rate.

Senator **Chafee**. Well, Mr. McIntyre, I think that this is a source of capital that we want to make available, not only to U.S. corporations without going through this convoluted process but also to the U.S. Government, as was pointed out is not currently available both for Fannie Mae and Ginnie Mae, plus the U.S. Government obligations themselves. Don't you think it is salutory for the U.S. Government to be able to get into this market, or have foreign capital able to invest in our securities?

Mr. **McIntyre**. Well, for two reasons I don't, Mr. Chairman. One, the idea of the U.S. Treasury engaging in massive tax haven activities is something I find repugnant as an American.

Second, in the short run—again, let me repeat—an influx of capital into our economy is detrimental to the economy in the current situation. We are still operating at below 80 percent plant capacity. What we need is increased demand for our goods, not increased capital. I think any economist in the country will tell you that.

Senator **Chafee**. Well, I'm not so sure we agree on that. I think the law of supply and demand provides that if more capital is available, then the interest rates will decline. I think if there is one thing this country needs it is reduced interest rates that will help the auto industry and all of the consumer industries that you are concerned with.

Mr. **McIntyre**. Well, I am certainly in favor of reduced long-term interest rates, and in fact we have been before this committee many times with the suggestion that running long-term Federal deficits is a bad idea.

But in the short run, the budget deficit has pulled us out of the recession that we were in for the last 2 years, and to move in the opposite direction in the short run will get us back into that recession.

Senator **Chafee**. All right.

Well, thank you all, gentlemen, for coming.

Mr. **Burke**. Thank you.

Senator **Chafee**. Now we will move on to our last panel: Mr. Rutherford, Mr. Romm, Mr. Davey, and Mr. Stevenson.

[Pause.]

Senator **Chafee**. All right. The Employee Benefit Research Institute [EBRI] is not testifying today, but they are submitting testimony for the record.

[The prepared statement follows:]

EBRI

T-20

SUBMISSION FOR THE RECORD

of the

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

HEARING ON

S.1066

held on

Monday, September 19, 1983

EMPLOYEE BENEFIT RESEARCH INSTITUTE
2121 K Street, NW/Suite 860/Washington, DC 20037/Telephone (202) 659-0670

INTRODUCTION

This nation has had a longstanding commitment to providing economic security for the aged. This commitment is most broadly emphasized by Social Security -- OASI, DI and HI. Employer sponsored pension programs and government incentives for their creation and maintenance are the second component.

- o Social Security benefit indexation has helped achieve economic security -- at a cost.
- o Employer pensions have been criticized vis-a-vis Social Security because they do not generally index benefits.

The 1963 Report of the Kennedy Commission on Pension Policy and the 1980 Report of the Carter Commission identified the absence of indexation as the critical shortcoming of employer sponsored pensions. Recent books published by the American Enterprise Institute and The Brookings Institution have emphasized this same point.

The debate raises two issues:

1. Should the indexation of employer pensions be mandated?
2. Should the indexation of employer pensions be facilitated?

From EBRI's review of studies and reports of the past, two conclusions are prominent.

1. Indexation should not be mandated for reasons of both employer cost and federal revenue loss.
2. Indexation should be encouraged to the degree that employers and employees make the judgment that they wish to afford it.

This bill under consideration today, S.1066, would facilitate the indexation of employer pension benefits on a cost shared basis. Attachment 1 presents a summary of the proposal and selected questions and answers.

Are Employer Pensions Indexed?

The Federal government does provide for full indexation of retiree benefits under the programs it sponsors (Civil Service Retirement, Military Retirment, etc.). A majority of state and local Governments provide for full indexation as well.

Private employers have not generally provided automatic indexation in the past. For the approximately 6 percent of employers who do automatically index it is not full indexation. Most frequently the adjustment is limited (capped) to 3 percent or 4 percent of pay.

Many additional employers provide ad hoc increases. One recent survey indicates that between 1978 and 1982 over two-thirds of large employers provided some postretirement cost of living adjustments. Tables from this survey by Hewitt Associates are appended as Attachement 2. This data is consistent with studies by the Bankers Trust Company of New York.

More and more employers are facilitating indexation by providing a retirement benefit option that includes a 3 percent (or higher) annual adjustment in return for lower intitial benefits. S.1066 proposes to allow such adjustments on a fully pre-funded basis without a reduction in the promised defined benefit.

Would S.1066 be Consistent with Current Public Policy?

It is the Institute's assessment that S.1066 would be consistent with current public policy. S.1066 would authorize a new approach to doing what public policy already encourages -- postretiremenet indexation. Using other methods than those proposed by S.1066, indexation is already allowed by law on a tax favored basis (taxes are deferred on the contribution cost until benefits are actually paid).

Would S.1066 Lead to Federal Revenue Deferrals?

Employers have the ability under current law to expend up to 15 percent of total cash compensation costs on retirement income programs. The nations largest employers are currently expending approximately 13 percent, and other employers less. Therefore the law already allows for additional federal revenue deferrals as aging of the workforce and a growing retiree population push expenditures higher.

To the degree that passage of S.1066 created a delay in consumption that would have otherwise taken place at normal retirement age the federal tax deferral would increase.

To the degree that S.1066 created substitution behavior -- meaning that the employer would provide the increase over time instead of funding them fully in the initial year -- there would be no change in federal revenues.

Based upon current indexation trends a realistic revenue deferral figure can be calculated.

Total Annual Defined Benefit Contributions	$ 40 billion
Times Cost of 17 Year 2% Index	17 percent
Cost of Index if all Plans Indexed	$6.8 billion
Times IRS Marginal Tax Rate Assumption*	12 percent
Revenue Deferral if all Plans Indexed	$ .816 billion
Revenue Deferral if 25% Indexed	$ .208 billion

Under the calculation approach for "tax expenditures" used by the Treasury Department the ultimate tax expenditure would be significantly lower than this tax deferral amount of 208 billion dollars. Because some level of substitution for postretirement increases that would have otherwise taken place is represented here, and because fewer than 25 percent of plans would probably use the S.1066 method.

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*12 percent is used since the payment is made at the time of retirement.

Would S.1066 Improve Economic Security of the Retired?

It is undeniable that a postretirement pension increase will improve economic wellbeing. An automatic index provides certainty for the retiree. A capped automatic index provides cost control at the same time for the employer and an absolute limit on potential federal revenue deferrals.

These advantages of the S.1066 approach are not attributable to current federal retirement programs. This fact, among others, has caused some of the Social Security financing problem. Should high inflation return, the government's flexibility would likely be enhanced by greater indexation of private employer pensions.

Should the Congress Pass S.1066?

Only the Congress can make this decision. The Institute's analysis has concluded that:

1. Over two-thirds of employers now provide some form of indexation and that S.1066 would provide one means of regularizing such increases.
2. S.1066 would be consistent with current public policy which encourages idexation.
3. S.1066 would likely cause limited federal revenue deferrals beyond current practice and none beyond what is possible under current law.
4. S.1066 could improve economic security for those retired individuals receiving postretirement increases as a result of its passage.
5. Greater indexation of employer pensions could increase long term government flexibility with regard to Social Security and other income transfer programs.

Attachment 1

3/83

SUPPLEMENTAL RETIREMENT BENEFIT TAX LEGISLATION

Background

Retirees today are facing many uncertainties with respect to the future earning power of their private pensions -- at the same time pressures on the Social Security system continue to grow. As a result, companies and concerned employees are taking a closer look at how they can be assured of a more sound financial future beyond their working years.

Supplemental Retirement Benefits (SRB's)

One innovative approach to the problem of maintaining the value of private pensions is to provide supplemental retirement benefits in the form of insured annuities or investment contracts -- jointly funded at retirement by employees and their companies -- which index other company-provided retirement benefits. Such supplemental retirement benefits could go a long way toward meeting rising costs during retirement and encouraging savings during an employee's working years. Such an approach also permits employers to establish a coherent program of retirement income protection.

SRB Legislation

Proposed SRB legislation would allow employees to elect, at or after retirement, to dedicate a portion of their tax qualified defined contribution plan (i.e., profit sharing and certain other types of plans) accounts, or other funds, to be matched by employer contributions, toward purchase of a "supplemental retirement benefit" in the form of an insured annuity. The annuity would provide an additional benefit equal to a percentage of a retiree's pension and would compound each year in value. More specifically, the bill, which amends the Tax Code:

- permits employers to make the necessary contributions for the purchase of supplemental retirement benefits at, or after, retirement; and,

- permits employees to incur no tax liability until amounts are distributed under the annuity.

Supplemental retirement benefits would be subject to the safeguards built into the Internal Revenue Code and ERISA as they apply to defined contribution plans. No attempt would be made to amend Title I of ERISA.

QUESTIONS AND ANSWERS REGARDING SUPPLEMENTAL RETIREMENT BENEFITS

QUESTION:

Why is a Supplemental Retirement Benefit Program ("SRB") important?

ANSWER:

Recent sustained periods of double-digit inflation have eroded benefits accrued by retirees during their careers. A supplemental retirement benefit is intended to preserve the relative buying power of pension payments.

QUESTION:

Why don't employers simply increase benefits payable under their defined benefit pension plan?

ANSWER:

Most companies' defined benefit plans (i.e., a plan which promises a specific benefit at retirement, such as $100 per month) calculate the benefits payable to an employee at retirement as a percentage of final or final average earnings. Provided an employer's salaries keep pace with inflation, the initial pension is generally adequate to meet a retiree's needs. However, once the pension is payable, its purchasing power can be rapidly eroded by even a modest rate of inflation, let alone that of recent history. To simply raise the benefits payable at retirement in anticipation of cost-of-living increases or to index defined benefit pensions to inflation is itself inflationary and too expensive for most employers.

QUESTION:

How have employers dealt with inflation on fixed retirement income in the past?

ANSWER:

Most large employers coped with this problem by increasing the pensions payable to retirees (as opposed to those who were entitled to vested terminated benefits) through "ad hoc" adjustments, payable out of general corporate assets. Traditionally, these "ad hoc" payments had to be renewed on a year-to-year basis and were increasingly expensive and administratively burdensome. From a retiree's viewpoint, ad hoc payments were also unsatisfactory since, given the contingent nature of the payment, the retiree could not rely on either the increments granted to his pension in previous years or the employer's decision to increase his or her pension in response to current inflation.

QUESTION:

In spite of these drawbacks, why can't employers continue to increase basic pensions using ad hoc payments?

ANSWER:

The Employee Retirement Income Security Act of 1974 ("ERISA") requires essentially that these gratuitous ad hoc payments be treated as retirement payments which must be funded prior to retirement through a tax-qualified retirement plan and must be subject to vesting requirements applicable to pension or retirement plans. In 1980 Congress amended ERISA to allow for nonretirement supplemental payments. However, neither the statute nor the proposed supplemental payment regulations issued by the Department of Labor permit a sustained annuity purchase program comparable to the SRB proposal.

QUESTION:

How does an SRB program work?

ANSWER:

A participant in both a defined benefit pension plan and a defined contribution plan (i.e., a plan which provides a retirement benefit equal to amounts contributed to a participant's account, plus earnings) maintained by the same employer will be allowed to elect to dedicate a portion of his account balance in the defined contribution plan (or from other sources, including personal savings) toward the purchase of an insured annuity. The cost of the annuity will be shared through a matching employer contribution made to the plan at the time of the participant's election. The annuity will provide an escalating percentage increase in the pension payable under his employer's defined benefit pension plan.

QUESTION:

What are the advantages to an employee of providing an SRB through a tax-qualified retirement plan?

ANSWER:

Employer annuities purchased outside a tax-qualified plan on behalf of an employee result in immediate taxation, to the employee, equal to the cash value of the annuity. In contrast, an employer may contribute to the purchase of a nontransferable annuity on behalf of a participant in a tax-qualified plan without causing the participant to recognize tax on the distribution until he begins to receive payments under the annuity, and then only to the extent of employer-derived amounts actually received in a given tax year. Finally, the use of a tax-qualified plan as a vehicle to provide supplemental retirement benefits assures employees that the benefits will be distributed equitably and that past and current increases in pension benefits will be continued.

QUESTION:

Why can't a supplemental retirement benefit be provided under current law?

ANSWER:

The overall limitations on amounts allocated to a participant's account is limited to 25% of compensation, up to a maximum dollar amount. Since the cost of purchasing an SRB annuity is high (ranging from approximately 70% to 120% of final pay), employer contributions to fund an SRB will in most cases exceed the current applicable limits.

QUESTION:

How is the employee who purchased an SRB annuity protected?

ANSWER:

By requiring that the SRB be provided through an annuity purchased from a licensed insurance carrier and by further requiring that the annuity be fully funded prior to the commencement of supplemental benefits, the risk that the benefit will not be provided is practically nonexistent. It is also conceivable that part of the employer portion of the SRB could also be provided through a defined benefit plan in conjunction with an insured benefit under a defined contribution plan (e.g., a 10-year guaranteed investment contract under the defined contribution plan with the remaining supplemental retirement benefits payable for the remainder of the retiree's life from the defined benefit plan). However, since the defined benefit portion would be subject to existing funding requirements and guarantees by PBGC, employees who participate in such a program will be fully protected.

QUESTION:

May the SRB annuity be provided through a profit sharing plan?

ANSWER:

Yes. Many employers use profit sharing plans to supplement defined benefit plan benefits since the costs of such plans can be more easily controlled. Often, to encourage employee savings, such plans provide for employee contributions which are then matched by employer contributions. Under present law, employer contributions to profit sharing plans must be contingent upon the existence of profits. Under the proposed legislation, an employer's contribution to purchase an SRB annuity could likewise be made contingent on profits; however, the legislation specifically provides that if the employer fails to make its contribution for any reason, the employee's contribution is to be returned at the employee's request. It should be reemphasized that once the annuity is purchased the SRB is guaranteed.

QUESTION:

May the SRB benefit be limited to employees who retire from service with the employer maintaining the SRB benefit, as opposed to employees who terminate service with an employer prior to retirement with a vested benefit ("terminated vested employees").

ANSWER:

Yes. Present law does not require an employer to provide the same benefits to both retirees and terminated vested participants, so long as the benefits are provided to a fair cross-section of employees. At the same time, employers have traditionally limited supplemental payments to retirees as both an incentive and a reward for faithful, long-term service.

Attachment 2

POSTRETIREMENT PENSION INCREASES

Many major U.S. employers granted postretirement pension increases in the late 1970s and early 1980s. Little data has been available regarding widespread company practices on postretirement pension increases granted in 1982 or anticipated for 1983. [Only companies with a defined benefit pension plan were asked to respond to this survey issue.]

Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
1. Has your company granted a postretirement pension increase to salaried employees during the period 1978-1982?	(283 cos.)	(53 banks)	(71 cos.)	(48 cos.)	(53 cos.)	(58 cos.)
• Yes	66%	81%	45%	63%	64%	81%
• No	34%	19%	55%	37%	36%	19%
If yes, in what years were increases granted? (multiple responses possible)	(186 cos.)	(43 banks)	(32 cos.)	(30 cos.)	(34 cos.)	(47 cos.)
• In 1978	27%	32%	9%	23%	20%	--
• In 1979	38%	37%	37%	33%	47%	34%
• In 1980	43%	56%	28%	47%	29%	51%
• In 1981	32%	37%	25%	30%	23%	38%
• In 1982	20%	23%	28%	7%	18%	23%

continued . . .

POSTRETIREMENT PENSION INCREASES (Continued)

Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
1. (Continued)						
If yes, how many increases have been granted during 1978-1982?	(186 cos.)	(43 banks)	(32 cos.)	(30 cos.)	(34 cos.)	(47 cos.)
• 1 increase	60%	63%	72%	70%	65%	40%
• 2 increases	30%	19%	28%	23%	32%	42%
• 3 increases	4%	2%	--	3%	2%	9%
• 4 increases	2%	2%	--	3%	--	4%
• 5 increases	4%	14%	--	--	--	4%
2. Will your company grant a postretirement increase in 1983?	(283 cos.)	(53 banks)	(71 cos.)	(48 cos.)	(53 cos.)	(58 cos.)
• Definitely yes	4%	8%	1%	--	4%	5%
• Probably yes	2%	4%	1%	2%	2%	2%
• No	73%	60%	85%	75%	77%	66%
• Not yet determined	21%	28%	13%	23%	17%	28%

continued . . .

POSTRETIREMENT PENSION INCREASES (Continued)

Survey Question	Overall Total	Banks	Manufacturing Companies With Annual Sales of: $100 to $499.9 Mil	$500 to $999.9 Mil	$1 to $2.49 Bil	$2.5 Bil and Over
3. If you did not grant an increase in 1982 nor plan to grant one in 1983, what is the primary reason for not granting an increase?	(154 cos.)	(23 banks)	(32 cos.)	(32 cos.)	(34 cos.)	(33 cos.)
• Lower rate of inflation	22%	22%	19%	15%	21%	33%
• Company's financial situation	33%	17%	25%	41%	44%	30%
• Little pressure from retirees	5%	13%	6%	--	5%	3%
• No pattern-setting precedent	18%	26%	22%	15%	15%	15%
• Other	22%	22%	28%	28%	15%	18%

continued . . .

POSTRETIREMENT PENSION INCREASES (Continued)

Additional Observations

- Thirty-four companies (22%) mentioned "other" reasons for not granting an increase in 1982 or 1983. Those reasons include:
    - the increase in benefit costs (7)
    - a belief that Social Security increases have been adequate in keeping retirees' income whole with inflation (5)
    - a favorable pension formula which makes present benefits adequate (5)
    - a company philosophy against granting pension increases (5)
    - a more critical need to improve benefits for active employees (4)
    - the last increase was granted within the last few years (3)

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October 4, 1983

The Honorable John Chafee
The Honorable Robert Packwood
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Re: S.1557 - Hearing held September 19, 1983

Dear Chairmen:

The Committee on Taxation of the Financial Executives Institute* submits these comments as its written statement for the record in support of S.1557, a bill to repeal the 30% withholding tax on interest payments to foreign portfolio investors. That bill, introduced by Senator John Chafee, was the subject of a hearing held before the Senate Finance Committee on September 19, 1983. This bill should be enacted to facilitate access of U.S. borrowers to international capital markets, and to avoid the cost of forming offshore financing subsidiaries by rendering the use of these entities unnecessary. Moreover, it would probably result in a net revenue gain to the U.S. Treasury.

Access to International Capital Markets. Free access of U.S. companies to international capital markets would satisfy the important national policy objective of encouraging the inflow of funds to the United States, thereby improving the U.S. balance of payments. It would minimize borrowing costs (to the benefit of the U.S. government and agencies, as well as the business community), and help to ensure an adequate flow of funds to meet the nation's capital requirements. Moreover, by increasing the supply of available capital, and thereby moderating interest rates, repeal of the withholding tax would help to reduce the Federal budget deficit. In this regard, net interest on the public debt constitutes some 13% of total Government spending.

Offshore Financing Subsidiaries. In recent years, unfavorable conditions in U.S. financial markets have prompted many firms to borrow offshore in support of their domestic operations. Such borrowings would be prohibitively expensive if interest

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*Financial Executives Institute is the professional association of 12,000 senior financial and administrative officers of over 6,000 organizations, large and small, throughout the United States and Canada.

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payments were subject to the 30% U.S. withholding tax, but are feasible if channeled through offshore financing subsidiaries in jurisdictions, most importantly the Netherlands Antilles, having tax treaties with the United States which provide an exemption from the withholding tax.

Debt issued by U.S. businesses through offshore financing subsidiaries, now totaling over $32 billion, has grown rapidly in recent years with $6 billion issued in 1981, and over $14 billion issued in 1982. Issuers are a cross section of U.S. industry, including such major companies as AT&T, Citicorp, DuPont, Ford, General Motors, Sears Roebuck, etc.

Recent press reports of the Treasury Department's plans to renegotiate the Netherlands Antilles tax treaty to eliminate "tax treaty abuse" have created serious concern that U.S. companies may lose access to international capital markets through financing subsidiaries established in that jurisdiction. The most appropriate way to relieve this concern is to provide statutory exemption from U.S. withholding tax for interest payments to foreign portfolio investors.

Revenue Aspects. The existing 30% withholding tax raises very little revenue for the U.S. Treasury because, as a practical matter, borrowings are not made in cases where the withholding tax would apply. Further, the U.S. Government absorbs substantial amounts (probably upward of $100 million per year) of income payments to the Netherlands Antilles through foreign tax credits. This revenue loss would be avoided if U.S. firms were free to borrow directly in foreign markets -- an action now effectively precluded by imposition of the 30% withholding tax.

In summary, S.1557 merits enactment. In view of the status of the ongoing negotiations of the tax treaty with the Netherlands Antilles, we are hopeful that action can be taken this year.

Very truly yours,

James P. Bryant
Chairman, Committee on Taxation

JPB/kgc

Senator **Chafee**. All right, gentlemen, why don't we proceed.

Mr. Rutherford, if you will lead off, followed in the sequence that we called off.

This is in connection with S. 1066.

STATEMENT OF BILL RUTHERFORD, SENIOR VICE PRESIDENT, HUMAN RESOURCES, SUN CO., INC., RADNOR, PA.

Mr. **Rutherford**. Thank you, Mr. Chairman.

My name is Bill Rutherford. I am the senior vice president of human resources for the Sun Co., which is an integrated energy company.

Senator **Chafee**. You are out of the shipbuilding business, is that right?

Mr. **Rutherford**. Yes, sir, we are out of the shipbuilding business.

We welcome the opportunity to talk to you today about what we are attempting to do to offset the impact of inflation on retire pensions, and tell you that Senate bill 1066 will permit such a program to work more effectively and we believe encourage other employers to adopt similar programs.

I am sure I don't need to remind you that sustained periods of even modest inflation significantly impact retirement income. Even a 5-percent inflation will impact the purchasing power of a fixed pension, as much as 25 percent in 5 years, and much more than that over a longer period of time.

As you know, many companies have attempted to deal with the impact of post-retirement inflation by granting supplemental payments from time to time, payable from general assets of the company. My own company has granted nine such increases since 1960, which represents an increase about every other year, and I believe that is typical for those companies that have granted those kinds of supplemental payment.

A second approach that is not too widespread, as you pointed out in your opening remarks this morning, in American industry is to provide automatic cost-of-living increases or adjustments to defined benefit programs.

There are drawbacks to both of these approaches. The ad hoc approach certainly provides no assurance that new increases will be granted and if not funded no guarantee or assurance that old ones will continue. This approach depends not only on the good will of the former employer but also on his continued financial success.

Obviously, the automatic cost-of-living approach includes unknown and potentially staggering costs which cause most employers to be either unwilling or unable to commit to this kind of an inflationary practice.

And with both of these approaches, neither really encourages the employee to save for retirement during peak earning years. We believe very strongly in the three-legged stool concept of retirement income planning which focuses on the public and the private systems sharing with the individual the responsibility of planning for future security.

The key is providing employees with a well-managed investment opportunity and matching company contributions to encourage savings for retirement.

My company has developed a new approach that attempts to bridge many of the concerns associated with the other two approaches. It's a supplement retirement income program that is more certain than the gratuitous supplement payments of an employer and more appropriate and cost-effective than indexed benefits. We call it ORBIT [Optional Retirement Benefit Income Trust]. The program is designed to augment basic benefits under a defined-benefits retirement program by permitting the employee to buy a guaranteed annuity from an insurance company at retirement from funds accumulated by the employee under a defined-contributions plan. And the cost of that annuity is shared by the company. The annuity will provide a 3-percent increase to the basic pension, compounded for 15 years, and payable for life, thereafter. And if I could, I would like to show you a chart of how that works, and I think we have one in the testimony I submitted as well as over here on the chart.

[Showing of charts.]

Senator CHAFEE. Yes, I see it here on the chart.

Now, tell me this. I see the chart and I see the amounts, and they are significant, but you are able to do that under existing law, apparently.

Mr. RUTHERFORD. No, we are not able to guarantee it under existing law, Senator. We have started this program, and we have been into it for a couple of years, but we are not permitted under existing law to buy the annuity through a tax-qualified plan, because the purchase of such an annuity would be a taxable event to the employee at the time of the purchase.

The only way we can work the program now is the way we do our ad hoc. We do it on a commitment basis, but no guarantee.

So the passage of Senate bill 1066 would permit that kind of a program to be much more effective, both for the guarantee to the employee and the cost effectiveness of the company. And we think other employers would be highly encouraged to model this kind of a program if this bill would pass.

Senator CHAFEE. OK.

Gentlemen, I assume everyone is going to testify in favor of this, but if you could touch on the concerns raised by Mr. Chapoton, that would be helpful.

Do you have any comments on what Mr. Chapoton said?

Mr. RUTHERFORD. Well, a couple of comments that he made seemed to recognize the potential nature of the problem. He seemed to believe, however, that there was no alternative to solving the problem other than the continued good will of employers who were willing to grant those ad hoc increases.

It seems to me this view is very shortsighted and that his concern with doing this outside existing ERISA rules focuses mainly on potential abuses. I think this bill makes so much sense that there ought to be room to work out those kinds of differences, because I really think this bill could go forward. It makes so much sense for the country, and it makes so much sense for solving this kind of problem. And believe me, we have wrestled with it over a period of time, and there aren't many alternatives. If he has some, I didn't hear them this morning.

Senator CHAFEE. Well, we all know this is a very, very complicated area. And as I understood what Mr. Chapoton was saying, he thought that he thought companies could already do it by putting the cost-of-living adjustment in the qualified defined benefit plan. Did you get that?

Mr. RUTHERFORD. I'm not sure that's what he meant. I know that really is not the case right now, with the ad hoc increases; although many companies do fold those into their qualified plans. That is a post-funding, not prefunding; it's simply after you have made the decision to grant it.

Now, you can fund those in a qualified plan so that they would continue, but that doesn't speak to the issue of the next increase.

Senator CHAFEE. All right.

Mr. Romm?

[Mr. Rutherford's prepared statement follows:]

STATEMENT BY
BILL N. RUTHERFORD, SENIOR, V.P., HUMAN RESOURCES
SUN COMPANY, INC.
IN SUPPORT OF
S.1066, THE SUPPLEMENTAL RETIREMENT ACT OF 1983

SEPTEMBER 19, 1983

Mr. Chairman, we welcome the opportunity to testify today in support of S.1066, the Supplemental Retirement Benefits Act of 1983.

The provision of retirement income in this country is often likened to a "three-legged stool." One leg of the stool is Social Security, another is personal savings and the third is the private pension system. We, like most large employers, believe in this approach to assuring and planning for retirement income security. Unfortunately, even modest rates of inflation, let alone the double-digit rates of recent memory, can destroy the value of what was expected to be an adequate pension earned over a career of hard work and dedication. While inflation seems to have abated for the present, we believe now is the right time to structure programs that will allow future generations of retirees to enjoy greater assurance that their retirement incomes will withstand the erosion of inflation. Addressing this problem requires appropriate public policy recognition and effective planning by the private sector .

For these reasons, we are here to tell you of our approach to protecting retirement income from inflation and to indicate our support for S.1066, which we believe will strengthen two legs of the retirement income stool...the private pension system and personal savings.

Sun Company, as you may know, is an integrated oil company with world-wide operations. Like most major companies, Sun maintains a carefully designed retirement program intended to meet the needs of its employees. This program is made up of two plans. One is a defined benefit pension plan, the Sun Company, Inc. Retirement Plan, which provides fixed retirement income and serves as a typical employee's primary source of retirement benefits. This plan covers approximately 14,000 employees and 8,000 retirees. The other part of Sun's retirement ptorgam is a defined contribution plan, which is called "SunCAP." This plan combines a cash or deferred arrangement (401(k)) with a thrift plan feature which together provide for pre-tax employee contributions, the first 5% of which are matched dollar for dollar by employer contributions. Upon termination or retirement, an employee's account balance is available in the form of a lump sum. More than 80% of eligible employees participate in SunCAP.

As noted earlier, sustained periods of inflation seriously threaten this retirement program. As in many companies, Sun's program is linked to pay and, in this way, keeps pace with changes in the standard and cost-of-living which occur during an employee's career. This self-adjusting mechanism stops at retirement, leaving retirement income vulnerable to even modest rates of inflation. For example, the income of a Sun worker who retires on a pension of $1,000 per month, assuming an inflation rate of only 5% per year, will be worth $724 after five years in real dollars; after 10 years, the individual's pension will be worth only $371; and by the end of 15 years (the approximate life expectancy of a retiree at age 65) a retiree will need $2,000 to buy what cost $1,000 at retirement.

In the past, Sun responded to the impact of post-retirement inflation by periodically granting non-qualified supplemental payments, payable from its general assets, which increase the basic benefits provided under the retirement plan. Sun granted nine such increases between 1960 and 1981. This practice is typical among many large employers, as is demonstrated by the attached study "Pension Increases for Retired Employees" conducted by the actuarial firm of Towers, Perrin, Forster & Crosby, which documents the widespread extent of this practice in all industries.

However, this unfunded supplemental approach has a number of significant drawbacks. First, the granting of the supplemental increases are discretionary on the part of an employer and a retiree must rely upon the goodwill of his former employer for this protection. Next, they are paid from the general assets of the corporation. As such, a retiree cannot be assured that the payments, even if previously granted, will continue throughout his or her retirement years. If the employer experiences financial difficulties, goes out of business, or is acquired, the retiree who may have become dependent upon such income may be left with an unenforceable promise to pay. Insofar as these benefits are funded out of current income and paid directly to retirees, they tend to reduce capital formation. Finally, this unfunded supplemental retirement benefit approach provides no incentive to employees to save for retirement during their working careers.

Another solution to this problem is to add automatic cost-of-living adjustment provisions to pension plans. However, fully indexing a pension benefit to cost-of-living changes represents a blank check with unknown and potentially staggering liabilities. As a consequence, private sector employers are generally either unwilling or unable to afford this approach. In addition, this approach also fails to provide an incentive for employees to save for retirement.

In response to these concerns, Sun developed a supplemental retirement income program which provides a stronger commitment to preserving retirement income than do gratuitous supplemental retirement payments and is more appropriate and cost-effective than indexed benefits. Sun's program is called the Optional Retirement Benefit Income Trust ("ORBIT") and is designed to augment basic benefits without changing the underlying design of Sun's qualified plans.

Under Sun's ORBIT program, participants in the Sun Retirement Plan and SunCAP who retire are given an option under SunCAP (once again, a defined contribution plan) to purchase an annuity from their accumulated account balances. The employee pays only a portion of the full cost of the annuity with Sun paying the balance. The ORBIT annuity provides, in effect, a total of 15 annual supplemental retirement income increases. Beginning in the second year of retirement, and for each of the next 14 years, the annuity pays an increase equal to 3% of the benefits paid in the prior year from both the basic Retirement Plan and ORBIT. This produces a compounding effect so that by the 16th year of retirement, the retiree's income has increased by 56% (3% compounded 15 times). At that point, income remains level for life. The annuity contains a 50% survivor benefit coupled with a refund feature which preserves the employee's contributions used to meet a portion of the cost of the annuity. All annuity costs are determined using unisex factors.

In designing this program, Sun explored various alternatives for protecting retirement income. Our first objective was to use tax qualified plans to fund Sun's obligation so that employees would not be in constructive receipt of taxable income prior to actual payment. The use of annuities provides the employee with the assurance that the benefit payments would be fully funded at retirement and that payments would be guaranteed by an insurance company throughout his or her retirement years. At the same time, annuities purchased through tax qualified plans are less expensive than those which could be purchased individually and the distribution of the annuity will not alter the availability of favorable lump sum tax treatment on other cash amounts distributed with the annuity.

Another key consideration was to share the cost of providing adequate retirement income with employees. In the past, supplemental payments were necessarily provided at employer expense. Partly to reduce the cost of the projected benefits, but mostly due to Sun's philosophy that employees should share the cost of inflation protection through savings, the ORBIT program was designed to be funded by matching employer and employee contributions.

Current law also requires an employer to ratably accrue a pension over the course of an employees' participation in the plan. However, it is difficult to encourage an employee to set aside hard-earned cash thirty years in advance of retirement based on assumptions of what the eventual cost and need might be. Because of this difficulty inherent in advance-funding retirement benefits with employee and employer funds, it was decided that the ORBIT annuity could be purchased at retirement, at the employee's option when the employee is more sensitive to his or her retirement needs and the economic environment.

In order to get ORBIT started, a transition period was established to help employees retiring in the years immediately ahead who wouldn't have as much time to save for their share of the cost of the 3% ORBIT benefit. Even though many current employees have been participating in Sun's capital accumulation programs for some time and do have enough accumulated to meet a 50% cost-sharing requirement, the transition period insures that all Sun employees will be able to participate. Thus, in the first year of the program Sun met 90% of the cost and employees paid 10%. This gradual phase-in has planned to last for 10 years, at which point Sun will be paying one-half of the cost of the annuity and the employee the other half.

The following examples illustrate how Sun's ORBIT program works:

Example 1

Frank retired on January 1, 1983 at age 62. His basic retirement benefit is $585 per month. He learns from Sun that an ORBIT annuity would cost $9,360. He pays 10% of the cost - or $936 - and Sun pays the other 90%, or $8,424.

During his first full year of retirement, Frank receives his $585-per-month benefit from the Sun Co., Inc. Retirement Plan (SCRIP) or $7,020 for the year. The following year, that benefit is boosted by 3% - or $17.55. Frank would receive this amount in a check from an insurance company, bringing his monthly retirement income from Sun's plans to $602.55. His total annual benefit in that year would increase from $7,020 to $7,231 for an increase of $211. The following chart describes how Frank's benefits grow annually:

Year of Retirement	Total Annual Benefit (SCIRP plus ORBIT)	Annual ORBIT Increase Over SCIRP
1	$ 7,020	--
2	7,231	$ 211
3	7,448	428
4	7,671	651
5	7,901	881
6	8,138	1,118
7	8,382	1,362
8	8,633	1,613
9	8,892	1,872
10	9,159	2,139
11	9,434	2,414
12	9,717	2,697
13	10,009	2,989
14	10,309	3,289
15	10,618	3,598
16	10,937	3,917
	Accumulated ORBIT Increase	$29,179

By the time Frank has received all 15 increases, his retirement income from Sun plans has grown to $10,937 annually or $911 per month, and it remains at that level for the rest of his life. When he dies, his surviving spouse receives 50% of the $911 monthly benefit, or $456 a month.

CJR/153A/8

Example 2

Marie retires at age 57 in 1993 and has a basic benefit from her Sun Retirement Plan of $920 per month. The cost of ORBIT is $18,400. She and Sun share the cost on a 50-50 basis, so the benefit costs Marie $9,200 in a one-time payment. Marie had been a member of SunCAP for many years, and has more than enough funds available to purchase the Orbit benefit. After her first full year of retirement, Marie's retirement benefit from Sun's plans grow by the 3% amount, from $920 to $947.60. If Marie lives for the entire 15 years of increases, her benefit would grow to $1,433.33.

However, Marie dies after six years of increases. At that time, her benefit has grown to $1,098.53. Marie's husband, Sam, will be entitled to a spouse's pension from Sun which will be increased by 3% a year - the ORBIT increase - for the remaining nine years of Marie's ORBIT contract.

Sam's pension at the time of Marie's death comes to $549.26. (This equals 50% of Marie's combined benefit from the Retirement Plan plus the basic 3% ORBIT Marie had earned at the time of her death.) When all nine increases have been completed, Sam's spousal benefit has grown to $716.65, and continues at that level for the rest of his life.

Sun's ORBIT and Current Law

As can be seen from the examples, Sun's program is intended to benefit employees by: increasing their retirement benefits; guaranteeing the source of those benefits during retirement years; providing flexibility in the approach toward funding the benefit at retirement; and encouraging employees to save for their retirement years.

Unfortunately, the current legal framework did not contemplate Sun's ORBIT Program any more than it contemplated recent periods of double digit inflation. Specifically, Section 415 of the Internal Revenue Code as presently written prevents the contribution to purchase the ORBIT annuity through a tax-qualified plan. Since the overall limitations on amounts which may be allocated to a participant's account is limited to 25% of compensation, up to a specified maximum dollar amount currently set at $30,000, and since the cost of purchasing an ORBIT annuity is high, ranging from approximately 70% to 120% of final pay, both high and low paid participants would be prohibited from receiving the company match at retirement, even when the costs are equally shared, in almost every instance.

The benefits of such a program as Sun's ORBIT Program are, we believe, self-evident. S.1066 provides a reasonable, circumscribed, exception to the Section 415 limits which would enable an ORBIT-type program to operate most effectively. Any technical drawbacks to the approach envisioned in S.1066 seem to us to be minor in comparison to the overall benefit this legislation confers. In pursuing this legislation we, and other companies like us, are not asking that the carefully planned structure of ERISA be harmed. Instead we ask only that Congress be responsive to the need to provide employers with the tools to enable them to help preserve what retirees have rightfully earned. Thank you.

HCW:bf

CJR/153A/11

SUPPLEMENTAL COMMENTS

BY BILL N. RUTHERFORD, SENIOR V.P., HUMAN RESOURCES, SUN COMPANY, INC.

ON S.1066, THE SUPPLEMENTAL RETIREMENT ACT OF 1983

Mr. Chairman, we are submitting this supplemental statement in response to issues raised by Mr. Chapoton on behalf of the Treasury Department in testimony before this Subcommittee which were critical of S.1066, the Supplemental Retirement Benefits Act of 1983. Mr. Chapoton's testimony was more fully detailed in Treasury's written submission, and we address our remarks to both his written and oral comments.

Specifically Treasury's opposition to S.1066 may be reduced to the following issues:

1. Benefit Accrual and Minimum Funding Rules. Treasury states "that even assuming that retirees currently are not adequately protected against increases in the cost of living, we are not convinced that it is necessary to provide an exception to the benefit accrual and minimum funding rules applicable to qualified plans in order to encourage employers to provide such protection."

    Although we feel we adequately addressed the need for this type of arrangement in our initial testimony, we feel it significant to point out that, according to a recent Department of Labor survey reported in the Washington Post of September 19, 1983, of the 84 percent of full-time workers in the nation's large and medium-size private companies covered by private retirement pension plans, nearly 40 percent were in plans that made occasional ad hoc increases. Thus we are dealing with a sizable universe and, since the SRB represents an improvement over both current approaches, the legislation addresses important concerns affecting this universe. At the same time the Treasury Department ignores the fact that these ad hoc increases represent legal exceptions to the benefit and funding rules.

In order to assist employers in supplementing the pension benefits of retirees, Section 409 of the Multi-Employer Pension Plan Amendments Act of 1980, amended the Employee Retirement Income Security Act by adding Section 3(2)(B), to authorize the Secretary of Labor to issue regulations treating supplemental payment arrangements as welfare plans rather than pension plans. Final regulations were issued by the Department of Labor which provide, essentially, that an employer may make payments out of general assets to provide supplemental retirement income to basic pensions equal to cost of living increases. Such supplemental payments are made out of general assets; need not be guaranteed by PBGC or any other means; and are not subject to the benefit accrual and funding standards cited by Treasury in their testimony.

As indicated in the TPF&C research study entitled Pension Increases for Retired Employees, submitted with our initial comments, these ad hoc increases are often later folded into tax-qualified pension plans in order to regularize the benefits and to provide some form of guarantee to retirees. These ad hoc increases are often initially structured to exclude certain classes of employees, such as vested-terminated retirees, who may be receiving basic benefits under the retirement plan and retain this limitation when folded into the qualified plan. These benefits are not accrued during an employee's career under the tax-qualified plan and, equally important, are not funded under the qualified plan until the benefits have been commenced to the employee. Thus, Treasury's position simply ignores the fact that such widespread practices represent legally backloaded* benefit accruals. S.1066 would permit in addition to other benefits, an employer to accomplish the same ends in a defined contribution plan.

The Treasury Department also states their opinion that an SRB arrangement is in the nature of a defined benefit plan; however, we note that their own testimony specifically recognizes that under current law, an employee may purchase an annuity under a defined contribution plan, using his or her account balance consisting of both employee and employer contributions, which is indexed to retirement payments under a defined benefit plan maintained by the same employer. Under such an approach the defined benefit pension serves merely as a base for computing the size of payments under the annuity. We fail to see why this arrangement under a defined contribution plan is considered a defined contribution plan distribution while, in Treasury's view, an SRB arrangement, which consists of the same elements, should be considered a defined benefit, subject to defined benefit accrual rules. Instead, it is our view that an SRB, as in the case of any annuity purchased from a defined contribution plan, is merely an annuitization of a defined contribution account balance.

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*Backloading, as accurately defined by Treasury is essentially the concentration on the benefit accruals in the employee's later years of service.

In sum, S.1066 offers a reasonable mechanism whereby the benefit once granted will be continued for the employee and requires that the benefit will be fully funded prior to the commencement of SRB benefits. We are puzzled by Treasury's refusal to recognize that an SRB approach represents a significant improvement over current practice and not an exception to rules which are currently legally circumvented.

2. Guarantee of Benefit. Treasury is also concerned that permitting an employer to fund an SRB in only one year is inconsistent with policies favoring a plan's ability to pay the promised benefits when due. They are specifically concerned, first, that the benefit is not guaranteed and, second, that since the employer's contribution is made at retirement, employers would be free to decide at any time to cease offering an SRB option under the defined contribution plan.

Leaving aside the response made in our original submission to this Subcommittee, that under current law such payments need not be guaranteed at all if paid from the general assets of the company or the fact that retirees must currently rely on the goodwill of employers if a cost of living adjustment is to be granted at all, we take exception to the criticism that these benefits are not guaranteed. Benefits provided under an SRB arrangement are guaranteed in two fashions: first, an SRB must be provided under an insurance contract underwritten by a licensed insurance carrier; second, by requirement of the legislation, premium payments to purchase the annuity contract must be made to a licensed insurance carrier prior to the commencement of the SRB.

With regard to earning the right to an SRB during an employee's career, Treasury suggests that an SRB program would create an unwarranted expectancy in employees that the SRB would be provided at retirement. While we are sympathetic to Treasury's concerns, we fail to see how the operation of an SRB program is inconsistent with current law or practice. Under current law an employer is free to terminate a defined benefit or defined contribution plan (which presumably create the same expectancy in employees as an SRB program) at any point in time.

Under current law, retirement benefits accrued under such a plan at the time of termination become payable to the employee and may not be reduced. Likewise, if the SRB program is terminated, benefits in pay status will continue, as will any future increases. In fact, while there may be a question concerning the funded status of the plan providing the primary retirement benefit in a termination, there is no similar question in the case of an SRB arrangement, which is fully insured and guaranteed. We recognize that employees forego future company contributions, but the ability of an employer to respond to changes in its economic reality is an important right, recognized under current law. Clearly if the Treasury's concern is discriminatory manipulation of the SRB program, this can be addressed in the legislation without destroying the flexibility provided by the legislation.

Treasury also expresses concern that individuals with a vested, terminated benefit need not be provided the opportunity to purchase an SRB arrangement. As noted earlier, it is common practice under the ad hoc supplemental arrangements to limit such payments only to individuals who have retired from a company, as opposed to those who have vested but who have left an employer's service, usually for another position. Benefits in the former instance are conceived as a reward for faithful service. At the same time there is a feeling that the individual has taken a job with a new employer (or employers) from whom he will retire in the future and that the cost of inflation protection rests more appropriately with his final employer. Consequently, the legislation was structured to permit an employer, if he should so choose, to model the class of eligible SRB retirees after the same class of individuals to whom such ad hoc supplemental payments could now be granted.

We recognize important policy considerations which may override this practice. If, for example, the legislation were amended to provide that a supplemental retirement benefit contribution would be required to be provided through the purchase of a deferred annuity to an individual at the time he or she terminates service after having vested in his primary retirement benefit, it seems to us that most of Treasury's objections would be dissipated.

3. Other Approaches. Treasury states that in addition to their other objections that "current law provides employers with several approaches to providing retired employees with supplemental benefits." They cite methods previously discussed, providing ad hoc increases out of general assets or providing for cost of living adjustments under a retirement plan. Upon further questioning, Mr. Chapoton could think of no further alternative methods. Treasury's written testimony does allude to "ways in which to alter the deductibility of employer contributions to fund supplemental benefits that will encourage employers to provide such benefits." We are puzzled by this later suggestion since direct ad hoc payments to retirees are currently fully deductible outside of the limitations of Section 404 of the Internal Revenue Code. We are curious as to what other incentives could be offered that would not negatively impact government revenues, yet would be substantial enough to encourage SRB-type programs to be implemented.

We welcome Treasury's willingness, expressed in their written testimony, to discuss other approaches as well as their suggested improvements to the SRB legislation and will be happy to discuss these with them; however, Sun and other companies have spent a great deal of time developing SRB-type programs and we are skeptical that realistic alternatives exist. Despite Treasury's statements to the contrary, we believe that no method achieves what S.1066 would permit:

a. Retirement Benefits. S.1066 permits employees to conveniently annuitize defined contribution accumulations. The company contribution at retirement provides an incentive towards devoting defined contribution accumulations towards retirement income and, as such, is consistent with national retirement policy.

b. Employee's Savings. Under the approach favored by S.1066, as opposed to other approaches, employees are encouraged to save for retirement, which once again, furthers national retirement policy. No similar encouragement is provided under either the ad hoc or indexed plan approach.

c. Flexibility. Under an SRB approach an employer is guaranteed the same flexibility provided under the ad hoc approach, with the major exception that benefits once granted will in all instances continue to be paid and that such benefits can be incorporated into a coherent retirement program which can be easily communicated and understood.

Moreover, unlike ad hoc payments, the decision as to whether to purchase an SRB is in the hands of the employee and is made at the time of retirement when the employee is in the best possible position to make an informed election.

Cost of living adjustments in tax-qualified defined benefit plans cannot be easily stopped once started. In this regard we call to your attention the recent case of Shaw v. IAM Pension Plan (No. CV 81-6076-AAH, May 9, 1983) in which a U.S. District Court for the Central District of California held that an amendment to a union's pension plan that attempted to phase-out cost-of-living adjustments violated the legal prohibition against reduction of a participant's accrued benefits. The court held that not only was the individual entitled to the benefit he had accrued at the time of the amendment, but also was entitled to any future increases which might result from cost of living adjustments which had not occurred at the time of the amendment. Apart from the issue of cost (discussed below) this ruling will further limit the number of employers (or unions) willing to incorporate a cost-of-living adjustment into a qualified plan.

Under an SRB arrangement, increases once granted would continue throughout the electing retirees retirement years in accordance with the terms of the SRB annuity. However, the SRB program does not restrict an employer's right to stop the program once it becomes unnecessary or should economic conditions mandate that such benefits not be offered. In every instance, however, SRB's once purchased would be continued to the retiree.

d. Cost Effectiveness. As cited earlier, the recent Department of Labor survey quoted in the Washington Post of September 19, 1983, states that only 3% of workers are covered by defined benefit plans with automatic-cost-of-living adjustments. The principal reason for the failure of cost-of-living adjustments to be included in defined benefit plans is, as Treasury's own testimony acknowledges, that "employers hesitate to provide employees with cost-of-living protection as part of the basic retirement benefit in a defined benefit plan because of the uncertainty of the financial obligation associated with being required to accrue and fund such protection over an employee's years of participation in the plan." In contrast, an SRB progam permits an employer and employee to share the cost of the inflation protection and is administratively feasible. As such, the employers' cost will be significantly reduced, making an SRB program an attractive alternative to employers who have been reluctant to pursue post-retirement cost of living indexation because of the potential expense.

In sum, we find Treasury's objections to the legislation reactive, and represent a failure to recognize real-world conditions. Instead their view represents a prescription ensuring that programs providing adequate retirement income security will never be adopted.

HCW:ga

STATEMENT OF ELLIOT ROMM, DIRECTOR, CORPORATE EMPLOYEE BENEFITS, INCO LTD., NEW YORK, N.Y.

Mr. **Romm**. Good afternoon.

My name is Elliot Romm. I am director of employee benefits for Inco, Ltd., and my purpose this afternoon is to explain the operation and concept of our savings plan, Escalator Annuity, which has been installed in three of the countries in which we operate, the United States, Canada, and the United Kingdom.

Three factors are relevant: Longevity is increasing, we are still dealing with a substantial imbedded inflation rate. For example, after 10 years in retirement, purchasing power at 5 percent inflation will erode about 39 percent. Finally, the historic response of ad hoc adjustments to the first two factors have a way of building up substantial increases in liabilities with increasing magnitudes, frequency, and number of pensioners.

As much as we would like it, these three factors won't go away. In fact, they suggest the need for long-range planning, which led to Inco's Escalator Annuity and Sun's ORBIT program. But it seemed useful to first cover some of the considerations we took into account in designing the program which led to the Escalator Annuity in the first place.

Senator **Chafee**. Say, I don't want to be nit-picky here, Mr. Rutherford, but you say that inflation at 5 percent a year, after 10 years, will cut a pension by almost two-thirds.

Mr. **Rutherford**. I apologize for the math in there, Senator. I think there was an error.

Senator **Chafee**. Do you mean it will reduce it to almost two-thirds?

Mr. **Rutherford**. Right.

Senator **Chafee**. In other words, 33 percent?

Mr. **Rutherford**. Right.

Senator **Chafee**. Because I think you and Mr. Romm differ. Mr. Romm comes up with in 10 years it will reduce it by 39 percent.

Mr. **Rutherford**. Well, it depends on if you are looking at the present value or what it goes to; 5 percent a year compounded over 10 years is going to be close to two-thirds.

Senator **Chafee**. All right.

Go ahead, Mr. Romm.

Mr. **Romm**. At any rate, we have to agree it's a substantial erosion after 10 years.

We looked at several considerations before arriving at the Escalator Annuity. We first considered conventional indexing and came to the conclusion it is beyond the means of Inco, as well as most other companies.

We next considered the proposition of excess interest and determined that inflation does not really pay for itself. The concept of "excess interest earnings" which has appeared in technical literature fails since a careful examination will indicate that the money has already been spent in other directions (early retirement subsidies and liberalized formulas).

And finally, we concluded that other mechanisms tend to institutionalize the concept of inflation itself. For example, about half of our labor contracts in the United States have automatic cost-of-living features; the Government indexes social security and pensions for the civil service and the military. All these mechanisms do provide a measure of relief, but they also contribute to inflation and perhaps corrupt the national will to deal with this.

Turning to the specific design of Inco's program, then, it is basically and simply a savings plan payout option which provides an annuity increasing annually by itself, that is by the the initial amount. The effect is to provide increasing supplements to the pension. The payouts start after age 65 and are designed to exhaust a given lump sum at the given rate of interest after 16 years at age 81.

We find that under typical circumstances—these include interest rate and the employee's age at retirement—a lump sum of 80 percent to 100 percent of a year's pay at retirement is enough to purchase post-retirement escalation at 6 percent, 7 percent, or more. The company absorbs the cost after age 81, together with the cost of a widow's pensions.

And we found a reasonable degree of acceptance by our employees. The program was instituted in North America in 1981. Since that time about 250 employees have retired with account balances of a half-year's pay or more, and of these 250 about 45 percent have elected the Escalator Annuity.

So, we know that the program is acceptable to employees and will do something to mitigate the impact of inflation. It has been extended to the United Kingdom, which has a relatively young savings plan, and may be extended to other locations where there are no savings plans at all.

Therefore, we had to consider the possibility of transition provisions to cover older employees at the start of the program who won't have the opportunity to build up significant account balances by age 65. At this point, I can report that several transition provisions are possible at an acceptable company cost.

Senator CHAFEE. Mr. Romm, I don't quite understand this. What does the employee do under this program prior to his retirement or close to his retirement? Is he making an extra contribution to a savings plan?

Mr. ROMM. No, we have had an established savings plan, since 1954. The employee contributes up to 6 percent, with the company matching between 50 percent and 100 percent of employee contributions, depending on the employee's age and service. (Employees may contribute an additional 10 percent with no company matching.) Shortly before retirement he is told the advantages of the Escalator Annuity, and the level annuity. He makes an election. Once he makes that election, the company will tell the employee what the payout will be and the amount of the company's subsidy.

Senator CHAFEE. Now, when he makes that election he does what? Does he have to make a contribution himself at that time?

Mr. ROMM. No, he would elect to divert all or a portion of the lump sum that has been built up in his savings plan for that purpose.

Senator CHAFEE. OK. Now, suppose he would decline to make that election, what would happen? Would he get the money back?

Mr. ROMM. He would get the money as a lump sum, yes.

Senator CHAFEE. So, now, during the time that he is making this contribution and the company is making its contribution, that contribution of the company is deductible to the company?

Mr. ROMM. Yes.

Senator CHAFEE. And nontaxable to the employee?

Mr. ROMM. Yes.

Senator CHAFEE. OK.

Well now, why do you need the legislation I have proposed?

Mr. ROMM. Well, I am here for two reasons. First, the legislation will simplify our design and employee communication problems. Right now we have to transfer the lump sum into our retirement plan in order to comply with existing legislation.

The other reason is: It works well for Inco, and we thought it might be useful if legislation made it simpler for other companies to adopt or adapt.

Senator CHAFEE. All right. But you are able to do it without this legislation?

Mr. ROMM. In a more complicated fashion, yes.

Senator CHAFEE. OK, Mr. Davey?

Mr. DAVEY. If I could just comment on that point, the problem would be that most companies, and particularly the employer contributions, would bump up against the 415 limit that we all addressed last year. And you have to remember those limits have been reduced, so that you have a defined contribution and a defined benefit limit, and this legislation is needed basically to address those limitation problems, particularly—remember this is a one-time contribution on the part of the employer at the year of retirement, or at the beginning of one of his retirement benefits, whichever is earlier. So you are bumping up against those limits, in terms of 414 in the Code. That's why there is a need for this legislation.

Senator CHAFEE. All right.

Mr. ROMM. I can second that. We would find our position much more comfortable with the proposed legislation.

Senator CHAFEE. OK.

Mr. Davey?

[Mr. Romm's prepared statement follows:]

Statement of Elliot Romm, Director of Employee Benefits, on Behalf of Inco Limited

Inco Limited - Savings Plan Escalator Annuity

In 1981 Inco Limited implemented an Escalator Annuity program as an integral part of the Company's savings plan. This summary will describe the concept and operation of our Escalator Annuity which has been installed in 3 of the countries in which we operate - U.S., Canada and the U.K. The proposed legislation reflects the same concept - but clarifies certain points and simplifies certain design features which were necessary to conform to existing legislation.

Inco Limited mines nickel, copper and precious metals and produces nickel alloy products. Our major markets are the steel, plating, automotive and high temperature superalloy industries. We are a Canadian corporation and have about 3,000 U.S. employees, 4,500 in the U.K. and 15,000 in Canada. Our 1982 sales totalled $1.2 Billion.

Inco's program has been designed to mitigate the impact of post-retirement inflation on fixed incomes. Three factors underline the need for such an arrangement:

- Longevity is increasing.
- We are dealing with a substantial imbedded inflation rate. After 10 years in retirement, 5% inflation erodes purchasing power by about 39%. The erosion increases to 44% and 49% with inflation rates at 6% and 7%.
- The historic response of ad hoc adjustments have a way of building up liabilities with increases in frequency, magnitude and number of pensioners. (The greater the frequency and magnitude, the closer the cost to conventional indexing.)

As much as we would like it - these factors will not go away. In fact, they strongly suggest the need for long range planning. Our present purpose is to describe the approach recently established at Inco Limited - the savings plan Escalator Annuity. It appeared useful to first discuss some of the considerations which led to this particular solution to post-retirement inflation:

1. First, conventional indexing involves prohibitive expense and is beyond the means of Inco and most other companies. For example, under typical circumstances, 6% indexing of a $10,000 annual annuity from age 60 will increase the total payout from about $225,000 to $465,000, an increase of more than 100%. The relationship is still imposing if these figures are discounted to present value at retirement.
2. Secondly, inflation does not pay for itself. Excess interest earnings during periods of inflation cannot finance indexing. Future pension liabilities of final pay plans are directly affected by the rate of salary increases and these are also influenced by inflation. Special studies suggest that the magnitude and direction of future pension costs are more influenced by the real rate of return than by the inflation rate itself. And the company's investment managers have advised that it is more difficult to achieve a given real rate of return as the inflation rate rises.

In any event, one might argue that any so called "excess interest earnings" have already been spent in the form of liberal regular and early retirement benefits, final pay pension formulas and so forth. In fact, in many instances and depending on salary levels, the combination of Company pension and Social Security benefits after-tax exceeds pre-retirement take-home pay. In short, adoption of "excess interest" would probably require a reduction in regular benefits.

3. Third, the cost of early retirement with subsidized reduction factors is already quite expensive. This would be compounded by any protection system covering the pre-age 65 period.

4. Finally, most protection systems tend to institutionalize inflation. For example, almost 50% of labor contracts have cost-of-living features. The Government now indexes benefits for Social Security, Civil Service and the Military. These and other mechanisms may provide relief but they also contribute to inflation and corrupt the national will to combat it.

These basic considerations then led to development of a program at Inco Limited reflecting the following principles:

- Any protection mechanism should involve a measure of employee participation.

- Pensions essentially protect against an inadequate standard of living when the individual must stop working, just as life insurance offers financial protection against premature death when productive capacity is high. Therefore, protection under Inco's program is directed toward the period after normal retirement age.

- The issue of inflation protection might be linked with a pension cap - a percentage of pay limitation for combined income from Social Security and the Company pension. This is reflected in the Inco design.

We have implemented this program under existing legislation. Among other things, this requires transferring funds from our savings plan to a retirement plan and applying an actuarial assumption to cover the company's subsidy. The proposed legislation would simplify our design and employee communications. However, our main interest is the extension of the concept to other companies - as an acceptable cost alternative to regular pension idexing.

Description of Inco's Program

The Inco program is now operating in three countries - the U.S., Canada and the U.K. We came to this concept after considering several alternatives - conventional indexing, ad hoc adjustments, actuarial reductions in regular pensions and excess interest earnings. The program we decided on at Inco builds on our separate established savings plan - which matches 50%-100% of employee contributions up to 6% of pay. This approach is particularly useful for companies with established savings plans. However, reasonable transition provisions can be developed for other companies so as to protect older employees at the start of a new program.

The basic concept is quite simple. Essentially, it involves a savings plan payout option that increases annually by the initial amount and has the effect of providing escalating supplements to the pension. The payments start after 65 and are calculated to exhaust the given lump sum at the given rate of interest after 16 years at age 81. The Company absorbs the cost after age 81 as well as a widow's pension for escalation up to certain prescribed limits. Depending on the circumstances this can operate to provide subsidized annual escalation up to 6%, 7% or more. At today's interest rates we find that typically an amount equal to 90%-100% of final annual pay is enough to purchase 6% or 7% annual escalation.

This may not seem so different. After all most companies with savings plans permit payouts as level annuities. Income is immediately increased at retirement - but this will erode together with the basic pension. The approach developed by Inco recognizes that employees will need increasing total income in later years.

The following chart shows the plan in operation. It assumes a basic pension of $10,000 and enough of a savings plan account to purchase annual escalation of 6% from 65 (say - an account balance of 90%-100% of pay at 62 or 63). Then the $600 would increase to $1,200 at 67 (2 x), $1,800 at 68 (3 x) and so on until $8,400 from age 79. The effect is 6% annual escalation in the basic pension.

Age	Retirement Plan	Escalator Annuity From Savings Plan	Total Income
66	$10,000	$ 600	$10,000
67	10,000	1,200	11,200
68	10,000	1,800	11,800
69	10,000	2,400	12,400
70	10,000	3,000	13,000
71	10,000	3,600	13,600
72	10,000	4,200	14,200
73	10,000	4,800	14,800
74	10,000	5,400	15,400
75	10,000	6,000	16,000
76	10,000	6,600	16,600
77	10,000	7,200	17,200
78	10,000	7,800	17,800
79	10,000	8,400	18,400
80	10,000	8,400	18,400
81	10,000	8,400	18,400
82 on	10,000	8,400(Company provided)	18,400

Discussion of Other Considerations

The basic concept is simple but the implementation rather complex. The remainder of this discussion will focus briefly on 4 areas: coordination of various disciplines, experience as to employee elections, impact on ad hoc increases and transition provisions for relatively new savings plans.

Disciplines involved. Several disciplines are involved - actuarial, legal, financial, tax, administration. We have developed a rather complex computer program working closely with our actuaries and can now produce an estimate with reasonable efficiency once all the data is available.

Employee participation. And this leads to extent of participation - number of employees electing the option. The program was instituted in North America in 1981. Until the beginning of 1983 about 250 U.S. employees retired with account balances of one-half year's pay or more. About 45% of these have elected Escalator Annuities.

The major portion of U.K. retirees have elected this option - but figures are distorted because of a generous transition allowance for older employees at the start of the program. Meaningful figures are not yet available for Canada since effective communications were only recently instituted. It appears that participation will increase as employees can plan, become accustomed to the concept and account balances accumulate.

Relationship to ad hoc increases. Inco is basically interested in establishing a mechanism so employees can protect themselves if they want to - much as with group life insurance. Basically, we feel employees should be provided the opportunity to protect themselves. But they have to participate and make the election.

This is somewhat related to the continued feasibility of ad hoc pension adjustments. In the past, when we considered an ad hoc pension increase, we first constructed 3 models for each of 3 countries in which we operate (U. S., Canada and the U.K.) - 9 models in all. We looked at total original after-tax retirement income by year of retirement, increases in the CPI and current after-tax retirement income. This gave some indication of the erosion and provided a frame of reference in determining the adjustment.

This worked reasonably well up until, say, 1974 or 1975. Among other things, Social Security had increased more than the rate of inflation. This provided a certain margin and the inflation rate was more moderate than the recent past. But this won't work as well in the future. Adjustments of the same magnitude as in the past will not provide the same degree of protection. Putting aside the fact that these adjustments will apply to more and more pensioners, increasing magnitude and frequency would probably impose an unmanageable burden.

This situation is not unique to our Company. Consequently, the proposed legislation is particularly important so that employees can be helped to help themselves.

Transition provisions. We believe the program is acceptable to employees and will do something to mitigate the problem of inflation. We have extended the program to the U.K. where there is a relatively young savings plan and may extend it to other groups where there are no savings plans at all. So we had to consider transition provisions for older employees, say, 55 and over at the start of the plan, who will not have an opportunity to accumulate sufficient balances. Further technical detail is not appropriate for this brief description. However, at this point we can report that several transition provisions are possible involving acceptable cost levels.

* * * *

In summary, Inco's Escalator Annuity basically involves a specially designed payout of accumulations built up under the Company's savings plan. It has been designed to help employees help themselves against the threat of post-retirement inflation, at an acceptable company cost. The program has operated successfully at Inco and we hope acceptance of the proposed legislation will encourage extension of the concept to other companies.

STATEMENT OF EDWARD J. DAVEY, EXECUTIVE DIRECTOR AND GENERAL COUNSEL, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. **Davey**. I just want to make a few points. First of all, thank you for letting us testify.

Let's remember that this is a voluntary program. You are not mandating this program; it's a voluntary program on the part of the employees and the employers, and I think that is something that should be remembered.

Second, I think this is a beginning stage or a beginning attempt to deal with a problem that I think has got to be addressed, and that is, inflation and the undermining of pension retirements.

Indeed, we expect that such an approach would be well received, since 74 percent of the pension plan participants surveyed in the Harris poll conducted several years ago said that they would be willing to contribute to employer-sponsored pension plans to protect their pensions against inflation.

The need for a secure income stream upon retirement will become more acute in the future. As the average age of the population in the United States increases, the demand for retirement income will accelerate. When the baby-boom generation starts to retire early in the next century, there is a good chance that our retirement income systems will be inadequate to meet the challenge. The recent social security amendments have increased the age at which full benefits will become available and have, in effect, reduced benefits. These changes may put greater pressure on the private pension system to increase basic retirement benefits. The increase in basic retirement costs may leave many employers unable to afford cost-of-living protection, as well.

S. 1066 permits an employer and its employees to share the cost of providing inflation protection and provides the employee the assurance—which is not the case under ad hoc arrangements—of receiving such protection through the purchase of an insurance contract.

We support the concept expressed in S. 1066, which we believe will strengthen the private pension system. However, we urge you to modify the bill in one respect.

Under the current version of the bill, the supplemental retirement benefit option is available only to those employees participating in both a defined benefit and a defined contribution tax-qualified plan. For example, if there is only a defined contribution plan, this program wouldn't be available, and we are suggesting maybe the bill is a little too narrow in that respect.

We believe that the added protection provided by the bill should be expanded to cover participants in all tax-qualified retirement plans. There is no tax avoidance involved here, since participants who elect the supplemental retirement benefit will be taxed on the additional benefit when paid to them.

Now, I would like to comment just on one point that you made with respect to Mr. Chapoton's testimony on current cost-of-living indexing in plans. It is very true that a defined benefits plan could have built into it a cost-of-living index provision in the very beginning of that plan rather than making periodic ad hoc cost-of-living adjustments. The problem is, as the Post article today pointed out, only 3 percent of employers are willing to take on that open-ended liability. I mean, this is the problem, let's face it, that we had with social security—automatic indexing all the time.

Senator **CHAFEE**. I am amazed that anybody would take it on.

Mr. **DAVEY**. Exactly. And the point is that I think that this is a much more reasonable approach to the problem.

Second, Mr. Chapoton seemed to be pointing out a concern about prefunding or minimum funding. Ad hoc cost-of-living arrangements are not prefunded; they come out of corporate treasury money. The company can go under or if it is a bad year, and therefore those people who have depended on those ad hoc arrangements, would not get those ad hoc increases. On the other hand this legislation provides a contribution on the part of the employer and employee at one time to purchase an insurance contract. So there is much more stability in this arrangement than in any of the current arrangements now provided.

Senator **CHAFEE**. OK. Well, thank you.

Mr. Stevenson?

[Mr. Davey's prepared statement follows:]

STATEMENT
OF THE
ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and members of the Subcommittee, my name is Ed Davey, Executive Director of the Association of Private Pension and Welfare Plans, Inc. (APPWP). The APPWP is a non-profit organization found in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The Association represents some 600 organizations located across the United States. Our member firms include hundreds of plan sponsors--both large and small employers alike. Additionally, our membership includes leading organizations from every element of the employee benefits community which supports the nation's private benefit system: investment firms, banks, insurance companies, accounting firms, actuarial consulting firms, and various others associated with the employee benefit plans. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

We appear here today to testify on S. 1066, a bill to provide participants in certain tax-qualified retirement plans with a mechanism to grant annual cost-of-living increases to protect against inflation. We commend you Mr. Chairman and your co-sponsors for proposing a solution to the problem that retirees will face if inflation again heats up in our economy. We strongly favor an approach like S. 1066 because it addresses the problem, without mandating coverage, by allowing an employer and its employees to voluntarily enter into an arrangement to protect the value of the participant's pension. Indeed, we expect that such an approach would be well received since 74% of the pension plan participants surveyed in a Harris Poll conducted several years ago said that they would be willing to contribute to employer-sponsored pension plans to protect future pensions against inflation.

We should not lose sight of the fact that a few years ago when inflation rates were much higher than today, inflation was the number one concern of Americans looking ahead to their retirement years. It is easy to recognize why inflation was viewed with such fear. An inflation rate of 6% will cause a pension dollar to lose .25 cents of its purchasing power in five years, .44 cents in ten years, and .69 cents in 20 years. At a 12% inflation rate, which we were accustomed to only a few years ago, a fixed pension would lose 2/3 of its value in ten years, and a crushing 90% in twenty years. The flipside of this unfortunate picture is the cost to the employer of providing its employees with a pension which keeps pace with inflation. A mere 1% inflation rate costs a company 10% more over the life of the pension than if there had been no inflation. If the inflation rate runs at 5%, the cost increases by 54%.

The need for a secured income stream upon retirement will become more acute in the future. As the average age of the population of the United States increases, the demand for retirement income will accelerate. When the "baby boom" generation starts to retire early in the next century, there is a good chance that our retirement income systems will be inadequate to meet the challenge. The recent Social Security amendments have increased the age at which full benefits become available and have, in effect, reduced benefits. These changes may put greater pressure on the private pension system to increase basic retirement benefits. The concomitant increase in basic retirement costs may leave many employers unable to afford cost-of-living protection too.

During the recent inflationary period employers attempted to provide cost-of-living increases through ad hoc adjustments. This system was unsatisfactory for both employers and their employees. Many industries and businesses were hurt much more than others by inflation and simply could not afford to do what was necessary to maintain an adequate retirement income level without jeopardizing the survival of the business. Moreover, anxious retirees were never certain whether ad hoc COLA adjustments would be made because employers were reluctant to commit to such increases for fear that they would become locked in, under ERISA's concept of an accrued benefit, to having to provide COLAs on a permanent, and expensive, basis. Because of the high cost of such protection, employers feared that the commitment would threaten the survival of their business.

S. 1066 resolves this dilemma by permitting an employer and its employees to share the cost of providing inflation protection and provides the employee the assurance of receiving such protection through the purchase of an insurance contract. We support the concept expressed in S. 1066 which we believe will strengthen the private pension system. However, we urge you to modify the bill in one respect.

Under the current version of the bill the supplemental retirement benefit option is available only to those employees participating in both a defined benefit and a defined contribution tax-qualified plan. We believe that the added protection provided by the bill should be expanded to cover participants in all tax-qualified retirement plans. There is no tax avoidance involved since participants who elect the supplemental retirement benefit will be taxed on the additional benefit when paid to them. Moreover, encouraging employee savings programs under this option will offer the additional advantage of not only offsetting inflation, but helping to bring it under control, for increased savings would provide the investment capital needed to enhance productivity and thus moderate inflationary pressures.

We appreciate this opportunity to appear before the Subcommittee and give our views on the Supplemental Retirement Benefit Act of 1983. We would be glad to provide you and your staff any further assistance you may need as you consider S. 1066.

STATEMENT OF KEITH A. STEVENSON, ASSISTANT VICE PRESIDENT, EMPLOYEE BENEFITS DIVISION, AETNA LIFE & CASUALTY CO., HARTFORD, CONN.

Mr. **Stevenson**. Thank you, Senator.

I am here representing Aetna Life & Casualty. We are a company that has under management about $30 billion in pension assets. And in addition to that, we have conducted a very careful study of the whole issue of retirement income security. We have spent a great deal of time working on this inflation issue, while the President's Commission on Pension Policy, for example, was ignoring it. And quite frankly, I think we came up with the same list Mr. Chapoton came up with this morning. There is a very, very small list of things that you can do to protect retirees from inflation. And as Mr. Chapoton pointed out, I think there are four existing items, methods for providing some form of indexation:

There are ad hoc benefits;

The employee can make a contribution at the point of retirement;

There are periodic plus-ups; or

There is the completely indexed benefit.

And, Senator, in an ideal world, of course, we would have all of these operating to provide complete indexation of inflation that in this ideal world would probably be very low. But we don't live in an ideal world; inflation is high. Individuals, governments, and business make decisions in their own interests which sometimes yield inflation that is unpredictable, unstable, and very high.

Under those circumstances, this ideal world breaks down, and we see in practice that employers have not been willing to take the routes that Mr. Chapoton has suggested. We need a pragmatic solution to a problem that is going to be considerably greater in the future as we increase the number of retirees, as we increase the need that those retirees will have for funds to pay for some of the benefits which we now are able to provide through socially subsidized welfare programs.

I point out that the medicare system is in severe trouble; the medicaid system is in trouble; we have a large generation of people who are going to require long-term care. We can't continue to pay for long-term care out of medicaid. My generation of retirees is going to have to pay for more out of its own pocket, and to do that we are going to have to have supplemental indexation of some sort to protect us.

I think that this is the pragmatic solution at the moment. And under those circumstances, we have absolutely no hesitation in throwing our support behind the bill. We think it's what is needed.

If Mr. Chapoton has a proposal, a specific proposal, related to increased deductibility, we would be of course happy to discuss it and investigate it further.

Senator **Chafee**. What about his concerns that he felt that this was stepping outside of ERISA?

Mr. **Stevenson**. I think we are talking about a narrow exemption from some rules in ERISA that were never designed with inflation in mind. I think his principal concerns relate to the potential loss if an employer could cease to offer a supplemental benefit plan. But the truth is that an employer could also cease to offer a pension plan.

He is concerned, I think, that an increasing portion of the total benefit would be funded through the supplemental arrangement. That I don't think is true, because the supplemental arrangement is a function of the underlying benefits. Weaken the underlying benefit, and you weaken the capacity to supplement. I think that is not a concern.

Senator CHAFEE. In the Treasury Department's testimony, they have made certain suggestions dealing with this bill such as inserting a requirement that vested terminating employees can still participate in it; that is, before they get up to their retirement. What do you think of that?

Mr. STEVENSON. I think that that has some merit. I think, for those employees who terminate vested and elect to receive their benefits in the form of an annuity at retirement, and who in turn contribute either through their own savings, as your bill suggests, or perhaps through a defined contribution plan, those individuals, at the point of retirement, should have the same opportunity as those individuals who do retire.

I think one can address this concern in that realm without any difficulty.

[Mr. Stevenson's prepared statement follows:]

Statement of the

ÆTNA LIFE INSURANCE COMPANY

on

S 1066

SUPPLEMENTAL RETIREMENT BENEFIT ACT OF 1983

Presented by

Keith A. Stevenson

Before the

Subcommittees on

Savings, Pensions and Investment Policy

and

Taxation and Debt Management

of the

Finance Committee

United States Senate

September 19, 1983

TESTIMONY

I am Keith Stevenson, Assistant Vice President at the Ætna Life Insurance Company. I am appearing today on behalf of a company which has about $30 billion in pension assets under management and which shares with you a deep concern over the impact of inflation on the financial security of retirees.

We are very pleased to have the opportunity to add our public support to Senate Bill 1066, the "Supplemental Retirement Benefit Act of 1983." The support we bring is based both on our very substantial experience in the design, administration and management of pension plans and our own careful study of the problems involved in developing affordable, qualified pension plans providing meaningful levels of inflation protection to retirees.

In the last 40 years there has been a very substantial growth in the number of workers covered by employer-sponsored pension plans. Together with the expansion of the social security retirement system, this growth in private pensions accounts for much of the increase in the standard of living of the elderly occurring in this period.

Even during the last decade of very high inflation workers' pension benefits have been largely protected by the prevalence of defined benefit plans based on final average earnings. Very few pension plans have been able to afford to provide formal cost of living adjustments to retirees' benefits. And, in the private sector, these COLAs have almost always been small, typically no more than 3%. While some employers have provided periodic ad hoc increases in their retirees' benefits, these have neither kept pace with the inflation of the last decade, nor provided retirees with any real sense of security.

Simple compassion alone prompts concern over the impact of inflation on pensioners because of their very limited ability to adjust their incomes in response. Demographics, however, will increasingly cause concern over inflation and the elderly. First, retirees' life expectancy is increasing, and the longer they live the more severely will retirees feel inflation's effects. Even at a 5% annual rate, inflation will reduce the real value of an unindexed pension benefit by 60% over 20 years. Second, the increasing number of elderly people in our society is already beginning to strain the capacity of publicly sponsored social welfare systems. Medicare is in serious financial trouble. So is Medicaid and we cannot expect that program to continue to pay for the majority of the long term care received in our country. Inevitably, the retired of the next generation will be expected to bear an increased fraction of the costs of supporting themselves. Under these conditions, it is a matter of intense public policy concern that retirees' pension benefits be better protected against inflation.

Partially because we do not fully understand the causes of inflation and partially because inflation is sometimes triggered by actions outside our borders, we have difficulty anticipating what inflation will be in the future. Consequently, the investments supporting pension plans have not typically provided rates of return which kept up with inflation. Therefore it is very expensive for an employer to provide retiree benefits which keep up with inflation. The problem is compounded since the employer is simultaneously trying to maintain the real (after inflation) value of the wages and benefits of current employees as well.

There are employers who are actively trying to provide inflation protection for those retiring employees who are willing to share the costs. Among these are companies represented here today. In response to this interest, Ætna has developed a supplemental escalator annuity product to provide an inflation-related, compounded increase in the basic pension benefit. The advantages of the supplemental escalator annuity funded at the time of retirement are:

- They are easily communicated and understood
- They allow employee participation.
- They can be based on the most recent and therefore the most relevant experience with inflation.
- The employee is focusing on the economics of retirement - perhaps for the first time - and is therefore more interested in inflation protection.

- They are flexible, both as to the amount of inflation protection provided and as to the employer's obligations.

- The benefits can be guaranteed.

- Their costs can be controlled.

- They do not result in adverse tax consequences to the retiree.

However, there are unfortunate and unintended regulatory obstacles to our using such a product. Although it was never one of the goals of ERISA to discourage employers from sponsoring inflation protection, current regulations do just that. Since the employee exercises the choice to purchase inflation at the point of retirement, the escalator annuity is inevitable funded then. The substantial employer contribution required to fund reasonable inflation benefits at that point would generally violate ERISA's funding requirements and accrued benefit rules and exceed the Sec. 415 contribution limits.

S 1066 overcomes these problems and represents a reasonable and practical method for allowing joint employer and employee funding of an inflation-based escalator in an employer's defined benefit plan. Without interfering with the basic protections ERISA provides plan participants, this bill would greatly expand the capacity of concerned employers to provide cost of living adjustments to their retired employees. In turn, the example set by these employers is likely to expand the number of American retirees with meaningful inflation protection.

While we have not done detailed analyses of costs, we believe that the revenue impact will be small. In the short run, revenue losses will be small as pension plans slowly adopt supplemental retirement benefit plans. In the longer run, revenue losses will be low because of the relatively short income deferral period.

In conclusion, S 1066 represents a reasonable and practical approach to accomplishing a very important public policy goal. We support its enactment without substantial change.

Senator CHAFEE. Well, thank you very much, gentlemen. This is a very important area. Although you made the statement that inflation is down, I don't see any reason that the concerns are going to be lessened, particularly as we have these dramatic consequences, as you pointed out, with a relatively modest inflation rate of, say, 5 percent.

Mr. STEVENSON. I would also point out, Senator, that this kind of inflation protection benefits those people who live longer, and women as a group live longer than men. Women are the people who are the most adversely affected by an inability to index a pension benefit.

Senator CHAFEE. All right.

You know, a question that is unrelated to this testimony, but just because in the Inco testimony he was talking about those who retire at 62, and so forth, and the Sun testimony I think was somewhat along those lines: Do you find that you get a very substantial number of employees from your experience that choose to retire before 65?

Mr. ROMM. Yes; the majority.

Senator CHAFEE. The majority of your employees? And what age would you say they choose? I am not going to do anything, I'm just curious about this.

Mr. ROMM. I would say 62. Sixty-one or 62 is fairly typical.

Mr. RUTHERFORD. I was just informed that our own experience has been that the average age of our retirees over a long period of time has been about 60.5 years of age.

Senator CHAFEE. Sixty? Even before they can collect Social Security?

Now what is the arrangement there, that they are just willing to sweat it out somehow until they become eligible?

Mr. RUTHERFORD. Well, I suppose in our case one of the things that impacts that is the way our particular plan is designed. There is no early retirement discount from age 65 down to 60, and the discount starts at 60. So I'm sure that a lot of people, as soon as they reach the age where there is no discount of that pension, decide to retire.

Senator **Chafee**. It is discouraging in a way, I think, that people find their work so onerous or boring or nonremunerative, or something, that they want to get out.

Do you think many then enter a second career? Or are 99 percent of them just through, go to Florida?

Mr. **Rutherford**. I think most of them retire and go to Florida, and buy a house trailer, at that age. Now, there are people who retire earlier than that who do look for second careers. And as you know, the general economy has a lot to do with it. I think early retirement did slow down during periods of high inflation because of concern of going out on a fixed income during periods of high inflation. But I think when you look throughout all of the years early retirement is still the rule.

Senator **Chafee**. Do you find that, too?

Mr. **Romm**. I think it's a function of the retirement income that's available. If it's a generous plan and the employee has substantial service, those factors motivate toward an earlier retirement. So I think a lot depends on the liberality of the retirement plan itself.

Senator **Chafee**. OK. We thank you all very much, gentlemen, for coming. Your testimony was very helpful.

This concludes the testimony.

[Whereupon, at 4:49 p.m., the hearing was concluded.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

AMERICAN
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1120 Connecticut Avenue, N.W.
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ASSISTANT TAX COUNSEL
Paula D. Porpilia
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October 3, 1983

Roderick De Arment
Chief Counsel
Committee on Finance
U.S. Senate
221 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. De Arment:

The American Bankers Association supports legislation to repeal the 30 percent withholding on certain interest payments to non-resident aliens and foreign corporations. The bill, S. 1557, will assist U.S. borrowers by allowing them to use a simple and direct method to attract funds from foreign investors.

The Eurobond Markets

The impact of S. 1557 can be understood by recognizing the importance of the Eurobond market as a source of funds for U.S. corporate borrowers, including banks.

No large borrower of funds in the world today can ignore the Eurobond market because it is a sizeable source of capital and is growing more rapidly than the U.S. corporate bond market. The growing importance of the Eurobond market as a source of capital for U.S. companies can be amply demonstrated by the extent to which U.S. businesses have increased their borrowing in the Eurobond markets in recent years. U.S. companies represented 11 percent of new issues volume in the Eurobond and foreign currency bond market in 1980 and 21 percent of that market in 1982. Second, the amount of new issues by U.S. corporations in the Euro-dollar bond market has recently risen to the level of new issues in the U.S. bond market. In 1982 there were issues in the domestic market of $42.9 billion compared to new issues in the domestic market of $43.7 billion. The overseas capital markets have accounted for an increasing percentage of U.S. corporate public debt financing. The percentage has increased from 10 percent in 1980 to 28 percent of public debt financing by U.S. corporations in 1982. The total dollar value of Eurobond and foreign currency bond issues by U.S. corporations have increased rapidly in recent years, from $4.4 billion in 1980 to $14.5 billion in 1982.

Not only is the overseas capital market large, but its investors have somewhat different investment objectives in investing in securities than do U.S. domestic bond investors. Generally, Eurobond buyers look for bearer bonds, annual coupons, front-end discounts, maturities bunched in the five to seven year ranges, tighter call provisions, better credits; they are historically more interested in floating rate notes and warrants than U.S. investors. Borrowing in foreign capital markets enables banks to diversify their sources of funds to obtain the liquidity, pricing, and other terms necessary to enable them to function profitably as lenders.

Access to Foreign Capital

The foreign capital markets are not directly available to U.S. corporations (and the U.S. Government) because of the 30 percent withholding tax under Internal Revenue Code section 871 and 881, which is applied to interest payments to foreign investors. In this sense, the withholding tax generally does not act as a tax which raises revenue but rather as a tariff which restricts foreign investment activity to a large degree. As a result, U.S. corporate borrowers generally must obtain indirect access to foreign markets through establishing Netherlands Antilles finance subsidiaries. This method of borrowing through a Netherlands Antilles subsidiary avoids the imposition of the U.S. withholding tax on foreign investors through the application of the benefits afforded under the treaty between the U.S. and the Netherlands, as extended to the Antilles. The subsidiary borrows funds from foreign lenders and re-lends those funds, subject to the tax imposed by the Antilles, to the parent company in the U.S.

If the 30 percent withholding tax legislation is enacted into law, it will eliminate the need for U.S. corporations to use an indirect off-shore finance company route to obtain access to the Eurobond market. The result will be that many U.S. corporations will be able to tap foreign capital through the direct issuance of their debt obligations without the impediment of the 30 percent withholding tax. This will open new opportunities in the availability of raising capital in foreign markets. It would enable medium size and small businesses to raise funds from foreign sources for the first time, without the cost and complexity of setting up a Netherlands Antilles finance subsidiary. As pointed out by Senator Chafee, elimination of the 30 percent withholding tax will have the effect of reintegrating the two separate bond markets which now exist, U.S. and Eurobond (see Congressional Record, June 18, 1983, page S.9340). Alternatively, if this legislation is not passed, and if a suitable alternative means of continued access to the Eurobond market were not available, overseas capital markets would be closed to future offering by U.S. corporations. This would result in putting severe pressure on domestic capital markets, and would generally force refinancing of existing issues.

Need for Certainty

The existence of U.S. - Netherlands Antilles Tax Treaty presently provides a means for U.S. companies to obtain access to foreign capital markets. However, there is considerable uncertainly about the continuation of this tax treaty. The U.S. has been in the process of renegotiating its tax treaty with the Netherlands Antilles for approximately 2 1/2 years. It is uncertain whether any new treaty may include language which would continue to affirm the opportunity for U.S. corporations to have access to the Eurobond market through the Netherlands Antilles finance subsidiaries. Until recently, the Internal Revenue Service had approved the use of Netherland Antilles subsidiaries; however, the IRS has recently raised tax audit issues with regard to the legal application of the withholding tax to interest paid on Eurobonds by Netherlands Antilles finance subsidiaries of certain U.S. companies. If it is determined that these transactions are no longer exempted from the withholding tax, existing obligations of those companies would be adversely affected. And an unfavorable IRS ruling could force U.S. corporations to cancel any future bond issues through the Netherlands Antilles subsidiaries.

Revenue Considerations

Elimination of the tax on interest paid to foreign investors may increase U.S. tax revenue. In testimony September 19, 1983, Assitant Treasury Secretary Chapoton testified that, based on (1) current levels of Eurobonds issuances by Netherlands Antilles finance subsidiaries and the allowance of foreign tax credits by the U.S. for Antilles corporate tax imposed on subsidiaries, and (2) the amount of the U.S. tax collected under present law, the Treasury estimates that the net revenue gain would be from $35 - $50 million. Thus, the bill will not only eliminate a restraint on access to foreign capital, but it may contribute to reducing the budget deficit.

Bearer Bonds Under TEFRA

Euro-dollar borrowings through Netherlands Antilles finance subsidiaries are generally issued in bearer form because, *inter alia*, anonymity is a crucial requirement for many foreign investors who comprise the Eurobond market. Congress recognized the need for continued financing from Euro-dollar sources through the issuance of bearer obligations when it enacted section 310 of TEFRA, which exempts Eurobonds with maturities of more than one year issued in bearer form from the TEFRA registration requirements, subject to certain conditions.

Thank you for the opportunity to comment on the provisions of S. 1557.

Sincerely,

Paula D. Porpilia

Paula D. Porpilia

83-86

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS, BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY & THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON S. 1557, REPEAL OF THE 30-PERCENT WITHHOLDING TAX ON INTEREST PAID TO FOREIGN PORTFOLIO INVESTORS

September 19, 1983

The AFL-CIO is in opposition to S. 1557 which would eliminate the 30 percent withholding tax on interest paid to nonresident aliens and foreign corporations on U.S. source income. We opposed similar measures in 1980 and in 1975 -- as did a Congressional majority. Today's economic conditions demand that this latest attempt at repeal be similarly rejected.

Present law provides, in general, that interest, dividends, and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30 percent tax on gross amount paid, if such income or gains are not effectively connected with the conduct of a trade or business within the United States. This tax is generally collected through withholding by the entity making the interest or dividend payment to the foreign recipient of the income. For this reason, the tax is commonly referred to as a withholding tax.

Those advocating the repeal of the interest income portion of these provisions justify their position as a means to attract foreign capital, with a resultant benefit to the U.S. economy and the generation of jobs. In our view there is absolutely no reason to accept a blanket assumption that foreign investment in the United States creates jobs for Americans or is necessarily beneficial to the American economy. In fact, the type of investments that would be encouraged through eliminating the 30 percent withholding tax would, in the main, be speculative "hot" money that can and does move quickly and freely from country to country. Speculative capital that comes in to the U.S. temporarily as a result of tax preferences is not the kind of capital that creates jobs, increases productivity or contributes to the health of the economy. To the contrary, such flows merely add to instability and uncertainty.

In addition, most industrialized foreign countries allow their citizens to offset, through credits or other means, taxes paid to other countries against those levied in their home country. Thus, in these circumstances repealing the U.S. tax merely amounts to a transfer of funds from the U.S. Treasury to the treasury of a foreign government.

Repealing the present 30 percent withholding tax on interest income would add a new tax preference. We see no reason why foreign investors who enjoy the security, protection and profit from investing in the United States should be exempted from making some contribution to this nation's taxes. American investors are required to pay income taxes on their interest income to the U.S. government when earned in the U.S. And, except where waived by bilateral treaties, they also pay taxes to foreign governments on income earned overseas. It is impossible to reconcile a policy of high interest rates on U.S. citizens struggling to purchase a home or an automobile when at the same time, we encourage Wall Street to float U.S. corporate bonds in foreign markets using a tax break not available to American citizens. We note, for example, that in the past the Nation's large brokerage houses helped lead the attempt to repeal this provision.

As Americans we have long criticized those so-called "tax-haven countries" which, in an effort to lure capital, grant special tax exemptions. The AFL-CIO does not feel that the United States should follow the example set by these countries. In fact, in 1975 as part of the Tax Reduction Act the Congress eliminated some of the tax avoidance opportunities enjoyed by U.S. multinational companies that operate in the "tax-haven countries."

The AFL-CIO urges the rejection of S. 1557 which would eliminate the 30 percent withholding tax on U S. source income paid to foreign investors.

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October 7, 1983

Statement Regarding S.1557 Submitted by the Institute for Financial and Fiscal Studies

We appreciate this opportunity to express our concern over the possible enactment of S.1557, a bill which would exempt foreign persons from the present 30% withholding tax on interest income earned on certain obligations issued by U.S. persons.

Introduction

The Institute for Financial and Fiscal Studies is an association whose members comprise some of the major banks, trust companies and professional firms operating in the Netherlands Antilles. These firms are the heart of the financial sector of the Netherlands Antilles. Their activities are critical to the economic stability of the Netherlands Antilles. By virtue of the present tax treaty relationship between the United States and the Netherlands Antilles, it has been a long standing practice of United States corporations desiring access to the Eurodollar market -- that is, desiring to borrow United States dollars from abroad -- to establish a Netherlands Antilles finance subsidiary as a vehicle for borrowing Eurodollars. This practice, which dates back to the mid-1960's, was etablished with the aid and encouragement of the United States government and provided important assistance to the United States during its balance of payments crisis. The practice has been a mutual benefit to our two countries and, over the years, has developed into an accepted, efficient and low-cost method for U.S. companies to access the Eurodollar market. Enactment of S.1557 would discourage the use of Netherlands Antilles finance subsidiaries by most U.S. companies and would seriously damage the economy of the Netherlands Antilles - an economy which is already seriously imperiled, with increasing deficits, no foreseeable new sources of revenue, and 20% unemployment. This very real threat to the economic viability of our country is, in candor, the principal motivating factor in our submitting this statement. However, we also strongly believe, for the reasons detailed below, that enactment of S.1557 is not in the best interests of the United States.

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As an organization whose members are involved on a daily basis with assisting United States corporations with Euro-dollar borrowings, we bring a special expertise and knowledge to the issue which should be of special benefit to the Senate Finance Committee in assessing the advisability of pursuing this Bill.

Some Historical Perspective

The use of Netherlands Antilles finance subsidiaries by U.S. companies is not only of long-standing duration but also a well accepted and efficient system. The history of the development of this practice is further detailed in an appendix to this statement. The recent interest in proposals such as S.1557 is not generated by any dissatisfaction on the part of U.S. companies, with the existing practice, but rather because of a level of uneasiness that has been created regarding the status of the tax treaty relationship between the United States and the Netherlands Antilles.

At the recent hearings on S.1557 a statement was made that there appeared to be overwhelming support for the proposal. On the contrary, there does not appear to be any groundswell of support for the proposal (which has been soundly defeated in Congress in the past). The principal supporter of the proposal -- the Securities Industry Association -- has a been a consistent supporter of this proposal since it first surfaced in the

1970's. Aside from the representatives of the Securities Industry Association, there were five other witnesses testifying specifically on S.1557. Three of these witnesses testified in favor of the legislation; the other two testified against the proposal. In other words, aside from the Securities Industry Association, there were three witnesses for the proposal and two against -- hardly an indication of overwhelming support. We also note that the AFL-CIO has indicated its opposition to this proposal since 1980 and continues to oppose the proposal. In truth, the greatest opposition to S.1557 and similar proposals has not been heard from, and is not likely to be heard from unless and until the Bill is enacted into law. This is the general taxpaying public which has not focused on this Bill; we predict they will react strongly when they understand that Congress has totally eliminated a tax on foreign investors which is comparable to the tax required to be paid by U.S. investors on the same type of income.

A similar proposal to S.1557, although covering a broader category of otherwise taxable payments to foreign persons, was soundly defeated on the House floor by a vote of 301 to 119 in 1976. Essentially the same proposal was defeated on the Senate floor the same year by an equally convincing vote of 54 to 34. Several similar proposals have been made in the intervening years but none have made it to the floor of either chamber. We submit that the only reason that this proposal is receiving any attention this year is because of a number of unfortunate and ill-founded rumors that the negotiations between our two governments for a new tax treaty relationship are running into difficulty. In spite of recent rumors to the contrary, we are informed by our government that the treaty negotiations have made substantial progress and that the sides have narrowed their differences to a few remaining issues.

Recent Revenue Estimates Require Careful Examination

In what appears to be a contradiction of prior revenue estimates on similar proposals, the Treasury Department has indicated that it estimates that S.1557 would raise 35 to 50 million dollars in revenue. The Joint Committee on Taxation, in its pamphlet accompanying these hearings, has questioned Treasury's revenue estimates and suggested the possibility that this proposal could result in a substantial revenue loss. In 1980 when a similar, although admittedly broader, bill was proposed, the Treasury Department estimated that the proposal would result in a revenue loss of $36 million dollars in fiscal 1981, $39 million dollars in 1982, $43 million dollars in 1983, $47 million dollars in 1984 and $52 million in 1985.

On the surface, it would appear obvious that the proposal would result in a revenue loss as it is eliminating a tax presently in place -- that is, a 30% tax on interest income received by foreign persons. The Treasury Department's estimate of a revenue gain is based on the fact that the use of Netherlands Antilles finance subsidiaries increases the ability of some U.S. companies to utilize the U.S. foreign tax credit mechanism. While, to our knowledge, the methdology used by the Treasury Department to arrive at its revenue estimate has never been made public, we question that revenue estimate for a least three reasons: first, many U.S. corporations are unable to use foreign tax credits for a variety of reasons, including operating losses and low levels of foreign tax; second, there is no reason to assume that those U.S. companies that can increase the availability of foreign tax credits through use of a Netherlands Antilles finance subsidiary would cease to do so simply because there was another means of borrowing Eurodollars available; and third, if the proposal achieves its purported goal of increasing U.S. access to Eurodollars, interest income which otherwise would be received by, and taxable to, U.S. persons would, instead, be paid to foreign persons free of U.S. tax while still being deductible to the U.S. corporate payors.

The Alleged "Tariff" on Foreign Ownership Of U.S Capital Is Nothing More Than Proper U.S. Tax Policy of Neutrality Between U.S. And Foreign Taxpayers.

In 1980, the U.S. Congress enacted the Foreign Investment in Real Property Tax Act ("FIRPTA"). This measure increased U.S. taxation of real estate gains earned by foreign persons. One of the principal reasons given by Congress for the enactment of FIRPTA was that it was felt to be inequitable to allow foreign persons to escape U.S. tax on U.S. real estate income when U.S. persons are subjected to tax on the same income. The Senate Finance Committee is presently considering adding a new withholding tax to further assure that foreign persons pay their fair share of U.S. tax on U.S. sourced real estate income. Enactment of S.1557 would be in total contradiction to the stated reasons for FIRPTA. That is, if S.1557 were enacted, it would increase the ability of foreign persons to earn U.S. source income free of tax while U.S. persons not only are subject to tax on that same type of income but, at the behest of Congress, are being subjected to increased enforcement measures to assure all U.S. taxpayers fully pay tax on their interest income. To quote from Representative Charles A. Vanik (D-Ohio) when he opposed similar legislation in 1975:

> It is inequitable to exempt foreign lenders from tax on U.S. interest income while continuing to tax interest receive by U.S.

> lenders. It is a slap in the face to all Americans. . . we should not discriminate against U.S. savers and investors by repealing this vestige of taxation on foreign portfoilo income. We should not saddle the American taxpayer with a higher tax burden while foreign investors escape any U.S. taxation of their investment income.

Representative Vanik also noted that repeal of the withholding tax would not increase capital formation but would only result in a switch of investment. He also observed that enactment of the measure would aid tax avoidance and evasion.

An Increased Inflow of Dollars from Abroad is Not Desirable at This Time

It is well recognized that the U.S. dollar is presently too strong and its strength is impeding U.S. exports. The alleged increase in U.S. jobs resulting from the proposal (which we believe would be minimal at best) would be more than offset by the decrease in U.S. jobs resulting from a further erosion of U.S. exports. In addition, as noted by the Joint Committee on Taxation in its pamphlet, there is a serious concern that a stronger U.S. dollar is likely to further aggravate the already serious international debt crisis.

There Would Be Little Or No Job Transfers To The U.S.

Proponents of S.1557 argue that, not only will its enactment create new jobs in the United States -- a proposition we question -- but it would also result in a shift of jobs from the Netherlands Antilles to the United States. We submit that such an argument is untenable. While enactment of the Bill would undoubtedly result in a significant loss of jobs in the Netherlands Antilles (relative to our total population), thereby intensifying our already serious unemployment problem, the jobs that presently exist in the Netherlands Antilles as a result of the use of Netherlands Antilles finance subsidiares by U.S. companies are uniquely related to the Netherlands Antilles aspects of Eurobond financing. These jobs relate almost exclusively to the efforts required to establish Netherlands Antilles corporations and to obtain the appropriate Netherlands Antilles governmental approvals. The needs for which these jobs exist would simply disappear; they would not be transferred to the United States. Thus, the argument that the jobs would shift from the Netherlands Antilles to the United States is unfounded.

The Present 30% Tax Plays An Important Role in U.S. Tax Treaty Policy

The statutory 30 percent withholding tax on interest is an important bargaining chip in U.S. tax treaty negotiations. The statutory tax provides a significant inducement for other countries to enter into tax treaties with the United States and to agree to reduce or eliminate their withholding tax on interest paid by their residents to U.S. persons. In fact, the U.S. Treasury Department has made this very point in arguing for greater limitations on the ability of third country residents to obtain benefits of a tax treaty between the United States and another country. As has already been pointed out by other opponents to this Bill, unilateral repeal of the 30 percent tax would transfer a substantial portion of the resulting U.S. revenue loss to countries which have refused to eliminate their withholding tax on U.S. persons (such as Canada, Japan, and Switzerland). These countries, like the United States, use a foreign tax credit mechanism, meaning that when one of their residents pays a 30 percent tax on U.S. source interest, the resident can claim a dollar-for-dollar offset against his home country tax for the U.S. tax paid. As a result, the foreign investor does not bear the burden of the tax; rather, the foreign government reduces the tax it otherwise collects from its resident. Elimination of the tax, therefore, benefits the treasury of the foreign government in those cases, not the foreign investor. Thus, in many cases, the elimination of the tax would simply shift revenue from the U.S. treasury to foreign treasuries.

The Present Structure Does Not Discriminate Against Small Business

Another argument of proponents of the Bill which we feel is unfounded is that the present structure discriminates against small businesses. They argue it is too costly for a small company to float Eurobonds through a Netherlands Antilles finance subsidiary. Because of the efficiency of operations in the Netherlands Antilles, the costs of establishing a Netherlands Antilles finance subsidiary are small. Typically, the initial start-up cost will be in the neighborhood of $15,000.00 and annual maintenance costs thereafter in the neighborhood of $3-5,000.00. This is hardly a significant impediment to a business which is contemplating borrowings of sufficient magnitude to justify going to the Eurodollar market in the first place. Further, the proposed legislation imposes policing requirements on bond issuers in an attempt to alleivate the obvious increase in the potential for tax avoidance or evasion by U.S. persons if the withholding tax is eliminated. Most issues will be required to be issued in a manner to"reasonably . . . . ensure sale or resale only to non-U.S. persons", payment of interest must be made outside of the United States, and sale of issues in registered form requires statements to be submitted on behalf of each purchaser that the purchaser is a non-U.S. person. In addition, certain organizations could be tagged as "inadequate" and be subjected to the 30 percent tax and certain foreign corporations (controlled foreign corporations) would be ineligible for the exemption, meaning the issuer may have to withhold tax on some payees and not on others. We submit that the cost to U.S. companies of complying with these policing burdens is likely to equal, or perhaps far exceed, the present cost of issuing a Eurobond through the Netherlands Antilles.

Summary and Conclusion

We have attempted in this statement simply to highlight some of the more important policy reasons why enactment of S.1557 is inadvisable. There are many other sound reasons why the proposal should not be pursued, many of which are identified and excellently analyzed in the pamphlet distributed by the Joint Commitee on Taxation in connection with these hearings.

Our message is simply this: the present system -- which allows U.S. corporations to float Eurobonds through the Netherlands Antilles in an efficient and controlled manner, while not more broadly eliminating a tax on foreign persons -- has worked, and continues to work, well. S.1557 would not improve the situation nor can it be justified on policy grounds; it would simply further complicate an already overburdened Internal Revenue Code. Its chief affect would be to vitiate the long-standing, well-functioning partnership between the United States and an important Carribbean ally, a partnership that has served the interests of both countries well. Elimination of this joint endeavor would seriously threaten the economic viability of our country.*/

Finally, we wish to add one concluding remark regarding the real issue behind the interest in this proposal this year -- the renegotiation of the tax treaty relationship between our two countries. As noted previously, there are a number of rumors that have surfaced concerning the fate of these negotiations. The United States requested renegotiation of the tax treaty because of their concern over the extent to which residents of third countries could use that treaty and because of their concern that there were inadequate mechanisms under the existing treaty for the exchange of information between our two countries. We are informed by our government that our country has accepted that these two U.S. goals must be addressed in any new treaty and has diligently worked toward that end including already agreeing to the inclusion of the most detailed and comprehensive exchange of information provision to ever appear in a tax treaty. Also, as we noted earlier, our government has informed us that the negotiations are progressing well and the issues have narrowed to a few remaining issues. We share the confidence expressed by Assistant Secretary Chapoton in hearings earlier this year in the House of Representatives that a new treaty will be concluded before the end of this year.

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*/ The dependence that the Netherlands Atilles now has for its economic health on this tax treaty relationship stems from a joint effort of both countries which significantly assisted the United States in its balance of payments crisis This is one of many examples of areas in which the Netherlands Atilles has been of assistance to the United States over many years, including cooperation in curtailing tax evasion and in other law enforcement matters.

We again thank you for the opportunity to present this statement.

Submitted on behalf of the Institute for Financial and Fiscal Studies:

Stanton D. Anderson

Stephen A. Nauheim

Appendix

Background to the Development of The Use of Netherlands Antilles Finance Subsidiaries by U.S. Corporation

As noted in the introduction, the widespread use of Netherlands Antilles finance subsidiaries developed during the U.S. balance of payments crisis as a result of a program implemented by the U.S. government. The program, aimed at preventing devaluation of the U.S. dollar, adopted various measures to encourage U.S. companies to borrow abroad. These programs included the Interest Equalization Tax, the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, a relaxation of the no action letter policy of the Securities and Exchange Commission with respect to foreign offerings by U.S. companies, and, most importantly, the ruling policy of the Internal Revenue Service which, as noted by the Joint Committee on Taxation in its pamphlet prepared for this hearing, encouraged foreign borrowings through finance subsidiaries. During this period, numerous private ruling letters were issued by the Internal Revenue Service holding that no U.S. withholding tax applied to interest paid through Netherlands Antilles finance subsidiaries as long as the subsidiary debt to equity ratio did not exceed 5-1 and certain other conditions were met. In addition to the private letter rulings, a series of published rulings were issued to the same effect from the period 1969 through 1973. Once the balance of payments crisis subsided and the U.S. abandoned the fixed exchange rate system for the dollar, the Internal Revenue Service revoked its prior rulings. Nonetheless, U.S. corporations continued to utilize Netherlands Antilles finance subsidiaries, typically backed by opinions of counsel from the leading Wall Street law firms. The practice was tacitly accepted by the Internal Revenue Service in that there had never been a challenge to a properly structured Netherlands Antilles finance subsidiary in the almost ten years since revocation of the published rulings until last year. The IRS challenge to Netherlands Antilles finance subsidiaries -- a challenge which remains unresolved -- occurred throughout the country. It coincides with the ongoing efforts of the U.S. Treasury Department and the Netherlands Antilles government to renegotiate the existing tax relationship between our two countries. It is likely that this contoversy over the tax status of existing Netherlands Antilles finance subsidiaries (an issue which is not addressed in S.1557) can be resolved in the context of the present tax treaty negotiations.

Federal National Mortgage Association FNMA

3900 Wisconsin Avenue, NW, Washington, DC 20016
202 537 6770

September 27, 1983

Senator John H. Chafee
Chairman
Subcommittee on Savings, Pensions
  and Investment Policy
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This is to express my strong support, and that of the Federal National Mortgage Association (FNMA), for your efforts to increase the supply of available funds for investment in this country. You are to be applauded for your introduction of S. 1557, to amend the Internal Revenue Code to repeal the thirty percent tax on interest received by foreign investors on certain portfolio investments.

The bill has substantial significance to the future availability of funds for housing. FNMA strongly supports its enactment. The existing tax treatment of interest earned by foreign investors from certain debt obligations constitutes an effective tariff against such investments. The change that you have proposed to the tax laws could attract substantial foreign capital and, thereby, increase the supply of available funds for housing investment.

In recent years, the housing industry has been forced to find new sources of capital. Your legislation should materially augment such sources by broadening the market for the debentures of FNMA and other financial institutions that support housing. Allowing housing to have access to the world capital markets, and to better compete with large corporate borrowers for such needed funds, will ultimately benefit homebuyers.

In addition, new sources of money for housing will have broad positive effects upon the economy and on the quality of life in the United States. The availability of new capital for housing finance will not only benefit the housing industry, but also means jobs in construction, forestry, building materials, furniture and appliances manufacturing, as well as the numerous home service industries.

We strongly encourage the Subcommittee to take prompt action to report the proposal to the Senate floor before the Session expires. Once again, we commend you for your efforts in sponsoring and promoting this essential legislation.

Sincerely,

David Maxwell

DOM/mdk

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Dr. Mark J. Riedy
Executive Vice President
(202) 861-6501

1983 SEP 28 AM 10: 57

September 21, 1983

The Honorable John H. Chafee
Chairman
Subcommittee on Savings, Pensions,
and Investment Policy
Committee on Finance
United States Senate
Washington, D. C. 20510

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairmen:

This letter is submitted in connection with the joint hearings scheduled by the Subcommittees for September 19, 1983 to consider miscellaneous bills affecting tax and pensions, including S 1557. The Mortgage Bankers Association of America (MBA) respectfully requests that the letter be included in the hearing record.

MBA is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage orginators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

On behalf of MBA, I wish to express our support for and urge prompt passage of S 1557, which would exempt certain interest paid to foreign individuals and corporations from withholding taxes. The provisions of the bill that call for the repeal of the 30 percent withholding tax that foreign investors must pay on investment in U.S. corporations could have a most beneficial impact on the housing and mortgage finance industries of this country through the secondary market operations of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

Access to foreign capital for both FNMA and FHLMC could be most advantageous to the mortgage credit situation in this country. There has been increasing interest on the part of foreign markets in U. S. investment, but the 30 percent withholding tax hampers the U. S. borrower abroad because of the disadvantageous effective yield. As it stands now, the foreign investor faced with buying debt instruments subject to the withholding tax will simply turn to investments free of the tax.

The withholding tax exemption provisions of S 1557 are also included in HR 3025, pending in the House Ways and Means Committee. MBA has written Committee Chairman Rostenkowski supporting the legislation and urging Congressional approval.

It is our understanding that the Treasury Department, as well as FNMA and FHLMC, strongly support this measure. We respectfully urge prompt adoption.

Sincerely,

Mark J. Riedy

Dr. Mark J. Riedy

MORGAN STANLEY

MORGAN STANLEY & CO.
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

October 10, 1983

The Honorable John M. Chafee
Dirksen Senate Office Building
Room 567
Washington, D.C. 20510

Dear Senator Chafee:

This letter is written in support of S. 1557 and to discuss some of the economic consequences which would result from repeal of the withholding tax on foreign investment.

The proposal to eliminate the withholding tax on domestically issued bonds purchased by foreigners has raised concerns over a possible capital inflow which would cause the dollar to appreciate thereby harming exports and import-competing industries. Fluctuations in exchange rates are predominantly a function of trade flows, which are a reflection of production costs and efficiencies, and of capital flows, which are determined by relative interest rates and affected by considerations of political stability; fluctuations in exchange rates are rarely affected by the availability of investment choices. Because of the huge size of the markets in dollar denominated short-term securities and in foreign currencies and the relatively small net flow into dollars likely to arise from repeal of withholding, adverse effects on the U.S. economy, if any, are likely to be exceptionally small.

There are two possible financial flows which must be considered in evaluating the possible adverse consequences of withholding repeal: flows from dollar denominated eurobond issues to domestically issued securities and flows from foreign currency denominated assets into more liquid domestically issued dollar denominated securities. The first of these flows, from dollar eurobonds to domestic issues, carries no foreign currency consequences whatsoever since no transactions on the foreign exchange market are required.

An exchange rate effect might occur in the second case mentioned above, if an investor decided to shift from a foreign currency denominated asset into a dollar denominated instrument. The issue is whether these potential flows are large enough to affect exchange rates materially. First and foremost, it is unlikely that investors would switch out of foreign currency bonds into dollar denominated bonds simply because of repeal of the withholding tax, when tax-free dollar denominated eurobonds have existed for some time, and any foreign investor interested in acquiring longer-term dollar assets with no withholding tax presumably already owns such securities.

Although it is probable that there would be some switching from foreign currency denominated securities into U.S. treasuries if the withholding tax is repealed, experts in the international markets do not believe that event would cause investors to appreciably change the currency mix of their portfolios. The enormous size of the foreign exchange markets makes it most unlikely that material exchange rate effects will become visible.

I appreciate the opportunity to express my support for repeal of the foreign withholding tax and to address some of the economic consequences of such action.

Sincerely yours,

John D Paulus

John D. Paulus
Vice President & Chief Economist
Morgan Stanley & Co. Incorporated

OWENS-ILLINOIS

Jerome A. Bohland
Senior Vice President, Finance

September 27, 1983

The Honorable John Chafee, Chairman
Subcommittee on Savings, Pensions,
and Investment Policy

c/o Mr. Roderick A. DeArment, Chief Counsel
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

RE: September 19, 1983; S.1557--Repeal of Tax on Interest on Certain Foreign Investments

Dear Senator Chafee:

We appreciate the opportunity to offer our views on the currently proposed legislation regarding repeal of tax on interest on certain foreign investments (S.1557). Owens-Illinois is one of the world's leading and most diversified manufacturers of packaging products, and the Company's financial condition and results of operations are widely followed by investors and financial analysts. We support adoption of S.1557.

We believe that current law virtually mandates that for a domestic corporation to borrow funds offshore economically it must establish offshore finance subsidiaries and use tax treaties between the

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United States and other countries such as the Netherlands Antilles. Maintaining a tax withholding system which encourages U.S. companies to establish and utilize offshore finance subsidiaries is a complicated and wasteful procedure which ultimately increases the cost of capital funds for U.S. companies and contributes to inflation.

In addition, as foreign borrowing becomes a more important element of the financial structure of U.S. corporations, more countries desiring to serve as financing windows for U.S. borrowers may pressure for negotiation and ratification of similar tax withholding treaties.

By eliminating the current withholding tax on interest paid to foreign investors, direct U.S. investments may be attractive to more foreign investors. This could lead to major cash inflows to the United States which could be used to help finance domestic needs including the expected Federal deficit.

Therefore, in order to permit direct access to foreign financial markets by U.S. corporations, to eliminate the need for finance subsidiaries in treaty-protected nations, and to maximize investment in the United States which can be used to help finance the expected Federal deficit, we encourage adoption of S.1557.

Sincerely,

J. A. Bohland
Jerome A. Bohland

/vas

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N.Y. 10271 · (212) 608-1500

October 7, 1983

The Honorable John H. Chafee
Dirksen Senate Office Building
Room 567
Washington, D.C. 20510

Dear Senator Chafee:

This letter is submitted in support of S. 1557 and pursuant to the invitation which you extended at the joint subcommittee hearings of the Senate Committee on Finance on September 19, 1983.

We strongly believe that enactment of S. 1557 will have a significant positive, not negative, impact on the U.S. economy. Among the positive effects of the legislation are the following:

- U.S. companies will be able to borrow funds directly from overseas sources rather than indirectly through foreign subsidiaries.
- The U.S. Treasury and U.S. governmental corporations will be able to borrow longer term funds overseas.
- Foreigners will be encouraged to purchase U.S. corporate and government obligations having longer maturities than current procedures permit.
- U.S. tax revenues will not be diminished but will be somewhat increased.

Our position on these issues together with evidence in support thereof is more fully set forth in our testimony and in other materials that we have submitted in the past.

We are satisfied that the legislation will not adversely affect any sector of the economy. Accordingly, we wish to address that section of the Joint Committee Print, describing S. 1557 and other bills, dated September 16, 1983, which suggests the possibility that the increase in net capital inflows to the United States which would result from repeal of the withholding tax would strengthen the dollar and thus reduce exports and employment in export-related industries.

There are in excess of $500 billion of dollar assets held by foreigners and huge amounts of currencies move across the exchanges daily in response to various economic and political stimuli. However, there is, in our judgment, little

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likelihood that a foreign investor will decide to switch from non-dollar to dollar securities solely because of a repeal of our withholding taxes. As a practical matter, all Eurobonds denominated in dollars or any other currency are structured so that interest may be paid without deduction of U.S. and other withholding taxes and the abolition of the U.S. withholding tax per se should have little or no effect on the currency preferences of Eurobond investors. There is , however, as we have previously testified, a strong likelihood that investors will switch from dollar securities of non-U.S. issuers (including the Netherlands Antilles subsidiaries of U.S corporations) to U.S. issued dollar securities issued in the U.S. market, including those of the U.S. Government. Such switches will be due largely to the greater diversity of investments available in the U.S. domestic markets and to the greater liquidity of the U.S. secondary market. Switching existing dollar investments from non-U.S. to U.S. issued securities could serve to increase the supply of capital available to U.S. borrowers. (Our previous testimony indicated our belief that such switches could amount to $5 to $7 billion.)

It is very important to note that foreign exchange transactions involving net purchases of dollars are required if the dollar is to strengthen. Since there will, in our judgment, be no significant shift from non-dollar to dollar investments as a result of withholding tax repeal, there would be no strengthening of the dollar and no adverse effect on our trade balance. It is therefore our judgment that enactment of S. 1557 will not have any long or short term adverse impact on the U.S. trade balance, exports or related employment.

We appreciate this opportunity to elaborate on the international economic consequences of this important legislation.

Sincerely yours,

Michael H. Coles vkv
Michael H. Coles, Partner
Goldman, Sachs & Co.
For and on behalf of a committee
of the Securities Industry Association
consisting of:
    The First Boston Corporation
    Goldman, Sachs & Co.
    Merrill Lynch Capital Markets
    Morgan Guaranty Trust Company of New York
    Morgan Stanley & Co. Incorporated
    Salomon Brothers Inc

Tax Executives Institute, Inc.

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September 27, 1983

The Honorable John Chafee
Chairman, Subcommittee on Savings,
Pensions and Investment Policy

The Honorable Bob Packwood
Chairman, Subcommittee on Taxation
and Debt Management

Committee on Finance
SD-221 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Re: Statement on S. 1557 (Press Release # 83-177)

Dear Senators Chafee and Packwood:

Tax Executives Institute, Inc. submits this statement for inclusion in the record of the Subcommittees' September 19, 1983, joint hearing on certain miscellaneous tax bills, including S. 1557. That bill, which was introduced by Chairman Chafee and Senator Bentsen, would exempt foreign individuals and corporations from the 30-percent withholding tax in respect of certain interest payments. Tax Executives Institute heartily endorses S. 1557 and urges its prompt and favorable consideration by the Subcommittees.

Background

Tax Executives Institute (TEI) is a professional voluntary, nonprofit association of corporate and other business executives who are responsible for the tax affairs of their employers. TEI currently has more than 3800 individual members who represent approximately 1100 of the leading corporations in the United States and Canada.

No single industry dominates TEI. We represent a cross-section of the business community and believe that our diversity and dedication to the tax function qualify us to address issues concerning the administration of the tax laws and the effective implementation of tax policy. As the principal association of tax executives, TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of government and taxpayers alike.

As explained in detail below, TEI believes that S. 1557 would eliminate needless administrative complexities while keeping needed overseas capital markets open to American businesses. Moreover, as Assistant Secretary Chapoton testified on September 19, the bill would have a positive revenue effect, raising between $35 million and $50 million.

Current Law

Under current law, non-resident aliens and foreign corporations not engaged in a trade or business in the United States are subject to United States income taxation only on income received from sources within the United States. Interest paid by a United States corporation on debt obligations to such investors is treated as income from U.S. sources unless otherwise exempt. Under sections 1441 and 1442 of the Code, such interest is subject to a 30-percent withholding tax unless a tax treaty provides otherwise. Such treaties often do not provide relief from the withholding tax in the case of broadly distributed debt obligations. In order to obtain the benefit of a treaty's lower withholding rate or exemption, certain holders of bearer bonds would be required to file an ownership form with the debt issuer in order to claim the withholding exemption -- a burdensome complication that diminishes the market attraction of broadly disbursed issues.

Advantages of Exempting Certain Interest Payments From the 30-Percent Withholding Tax

United States corporations have been able to borrow in foreign capital markets at a lower cost, when the withholding tax can be avoided, than in domestic financial markets, which have been under great strain in recent years particularly because of large government deficits and the associated borrowing needs of the federal government. The availability of foreign capital markets allows U.S. corporations to proceed on additional job creating projects and capital investments in the U.S. and, of course, to build a better revenue base in the U.S. Allowing U.S. corporations to borrow in foreign financial markets without the onerous burden of the 30-percent withholding tax would permit a freer flow of funds into the United States, thereby decreasing the differential in foreign and domestic borrowing costs and consequently making U.S. firms more competitive.

In addition, enactment of S. 1557 would obviate the need for provisions in tax treaties regarding the reduction or elimination of withholding on interest and would substantially reduce the need for foreign finance subsidiaries.

Summary

Exempting interest on foreign portfolio indebtedness from the 30-percent withholding tax would facilitate business operations in the United States, eliminate needless administrative complexities, and result in additional U.S. taxes because of increased income and more competitive businesses. Consequently, Tax Executives Institute urges your Subcommittees to act favorably on S. 1557.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

By Paul A. Barrese
Paul A. Barrese
President

SENATE FINANCE SUBCOMMITTEE
HEARING ON MONDAY, SEPTEMBER 19, 1983

S. 1557

USAir Group, Inc. is a United States corporation whose business activity at present is the operation through USAir, a wholly owned United States corporation, of airline operations for the transportation of passengers, property and mail.

USAir is capital intensive having placed into service, during the three years concluding with 1982, five new Boeing 727-200 aircraft, twenty new DC-9-30 aircraft and six new Boeing 737-200 aircraft. In 1983, three new and two used Boeing 727-200 aircraft and twelve new Boeing 737-200 have been or will be placed in service. In addition, firm orders exist for five additional Boeing 737-200 and twenty Boeing 737-300 aircraft for deliveries during 1984, 1985 and 1986. Planned capital expenditures of as much as $250 million a year over a period of time necessitates accessibility to all financial markets.

In September 1983, USAir Group, Inc. borrowed $50 million through the Eurodollar market on advantageous financial terms at lower long-term rates than available domestically. This and other financings are essential for equipment modernization (productivity improvement and energy conservation), domestic business expansion and creation of new jobs, both to the airline and to the domestic aerospace firms.

The current mechanism for offshore financing is cumbersome and adds an unproductive element of costs which could be avoided under proposed legislation. The cumbersome mechanism also creates a longer time period to consummate such transactions which can be critical in the financial markets. A prior offshore financing effort was in fact aborted because of changing market conditions. Further, to avail oneself of the foreign capital, there is some tax payable to foreign nations which becomes a loss of revenue to the United States Treasury. This loss of revenue to the Treasury may not be major but is a concern to the United States corporation which feels trapped by the mechanism under which payment to foreign nations is required.

For the above generally stated reasons, and for the reasons more specifically addressed in the introductory statements by Mr. Gibbons to H.R. 3025 and by Messrs. Chafee and Bentsen for S. 1557, USAir Group, Inc. fully endorses the proposed legislation inherent in these Bills.

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